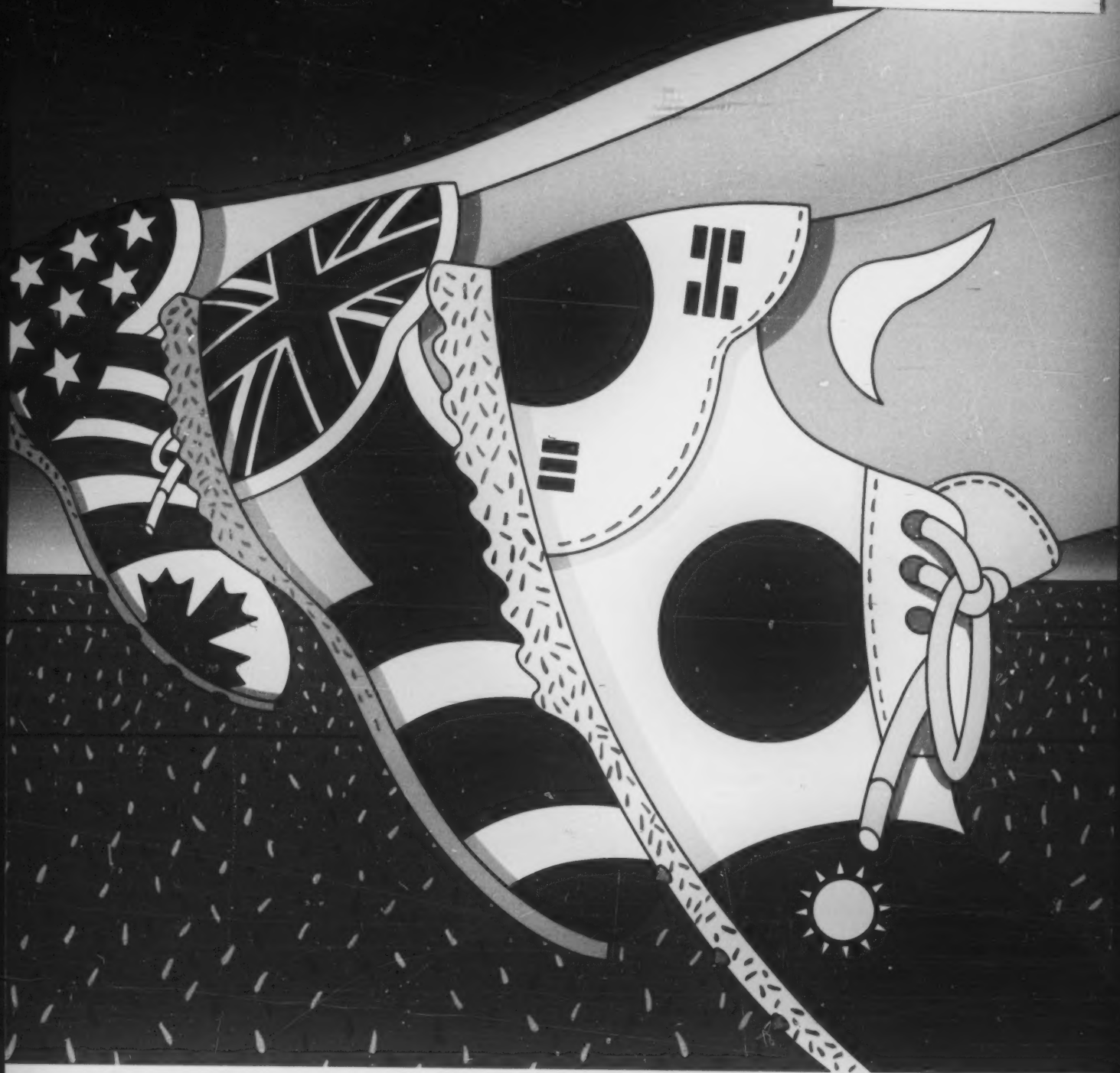


FORECAST

1990 / 1991



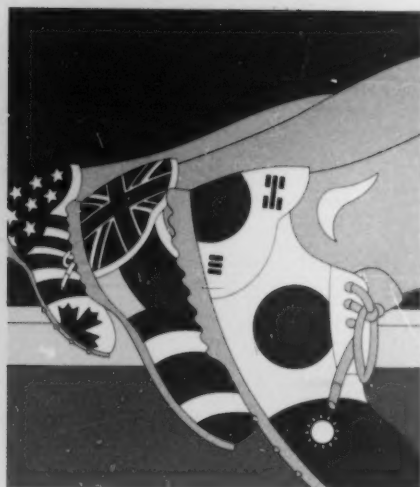
FIRST INTERSTATE TERRITORY EDITION

F **First**
Interstate
Bancorp

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Overview



The decade of the 1990s stands a very good chance of being the most prosperous of the century. This view is based on several important developments. The end of more than 40 years of cold war and the victory of capitalism and democracy over socialism and totalitarianism in the contest of ideas have set the stage for more efficient use of global resources.

In the coming decade, economic rivalries among North American, European, and Asian enterprises in a global arena will move us further down the path of economic restructuring. Deregulation, denationalization, privatization, and tax reform will continue. Freer markets mean that natural comparative advantage will

bring about greater productivity at a time when demographic trends also suggest a more experienced work force in major industrialized nations. Productivity growth in most of the major industrial countries has been fairly rapid during the past several years.

Global markets for financial and real assets, as well as tradable goods, will constrain the degree of discretion exercised by economic policymakers. This "policeman" role of foreign exchange, equity, and bond markets will help to lower the amplitude of fluctuations in inflation, interest rates, exchange rates, output growth, and employment. This less volatile environment will be conducive to higher saving and investment.

As Latin American nations finally begin to shake off decades of protectionist, oligarchic regimes and join the worldwide trend toward free market economies, trade and investment opportunities for North American, European, and Asian firms will be abundant.

"Europe 1992" will enhance the global competitiveness of European firms. Changes in American bank laws will eventually stem the erosion of the relative competitive position of U.S. financial institutions. The savings and loan restructuring plan will accelerate the consolidation of that industry in the United States.

The shift of attention away from "evil empire" images and concern about nuclear war toward economic competitiveness will prompt the United States to address more effectively domestic problems such as crime, drugs, and the poor quality of education.

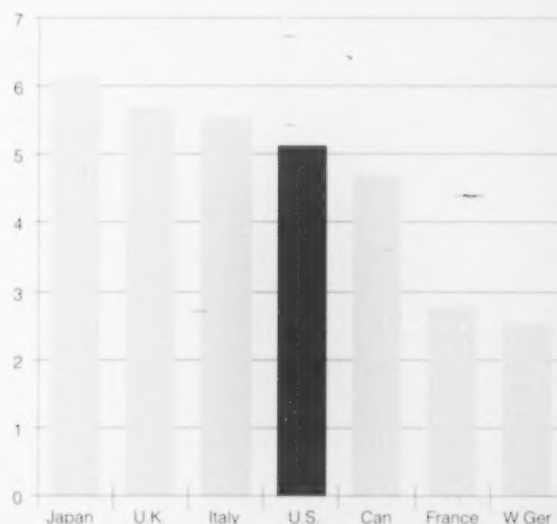
Faster Growth with Less Inflation

The forecast for the next two years is positive. Inflation in the United States peaked for this cycle in the first half of 1989 and will trend downward in 1990 and 1991. Internationally, inflation should settle at a lower level. At the same time, average growth of U.S. output and employment in the next two years will be above the slow pace of 1989.

-1-

U.S. Competes in Productivity Race

(Average annual increase in output per employee in manufacturing, 1983-88)



Interest rates will fluctuate in a fairly narrow range compared to the experience of the past two decades. For example, long-term government bond yields are forecast to remain in the range of about 7.5-8.5% through 1991. Similarly, the foreign-exchange value of the dollar will trade in a narrower range than in the past.

As is normal, not all sectors and regions will perform equally well. Both housing starts and automobile sales peaked for the past cycle in 1986, and then fell through 1989. We forecast a higher level of housing starts and auto sales for 1990 and 1991 than the estimated 1989 levels. Nonresidential construction, however, will be depressed through at least 1990 by high vacancy rates. Investment spending by businesses will increase in real terms in the next two years, but at a more moderate pace than in 1988-89.

The U.S. external trade deficit, after falling through 1989, will rise again in 1990 and 1991, although we do not expect it to reach its previous peaks. Nevertheless, the continuing deficit will mean strong inflows of foreign capital into U.S. financial markets. Foreign direct investment in the United States should also continue at a high level.

After rising to the 5.5-6.0% range early next year, the national unemployment rate will resume a gradual decline, reaching a low of about 5.0% by the end of 1991. By then, labor markets in certain categories and regions will be considered to be very tight once again.

U.S. Industries Prepare to Compete

U.S. industry has become much leaner and more efficient since the last recession; this is particularly true in industries such as metals, paper, and chemicals. In many cases, plant and equipment have been modernized, and labor forces have been trimmed substantially. As a result, otherwise cyclical manufacturing industries may be less severely impacted by a small or moderate downturn in the domestic economy.

In addition to the lower costs some manufacturers have achieved, relatively strong export demand will further bolster export-oriented manufacturers. Commercial aircraft and related industries, for example, can be expected to remain strong, offsetting the decline in defense-oriented contracting. Business equipment, especially computing and communication equipment, seems likely to weather a temporary slowdown.

The service and construction sectors are likely to experience weak sales and some job losses through the first half of 1990, particularly in areas of the country that are already performing below par. As consumer spending growth slows during the same period, retailers will face weak sales growth and declining margins and profits. Firms with high fixed costs, including those with large debts, may require further restructuring and refinancing pending the return of higher economic growth rates.

FI Territory Regains Lead

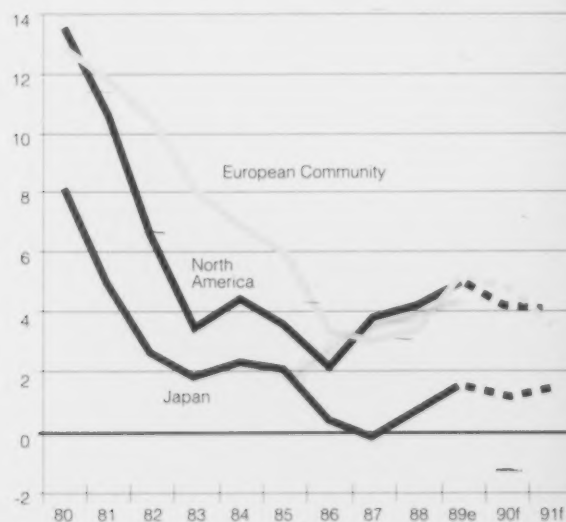
First Interstate Territory, a grouping of 21 states plus the District of Columbia, should benefit from the less volatile economic climate. Commodity price swings, which have produced serious economic cycles in the past, should be smaller in magnitude in the future.

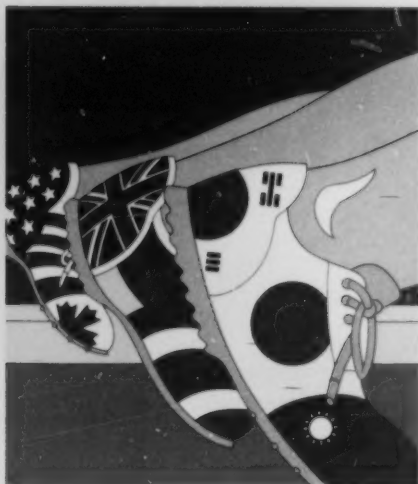
Most states in the region will feel some impact of the national slowing in late 1989 and early 1990. However, we expect the Territory to post employment growth slightly above the national average during the forecast period. The Pacific Southwest will record the highest employment growth within the Territory during the 1990-91 period.

--October 16, 1989

Inflation on a Low Plateau

(Average annual percent change in CPI)





The emergence of a unified European economy is adding a new dimension to global competition. Europe, North America, and Japan have become the three large economic and financial powers. During 1990-91, growth will remain relatively strong in the industrial countries, with inflation subsiding again after a slight upturn. Fixed investment is a leading factor in the strong growth performance. Large current-account surpluses will increase further the strength of Japanese and German financial institutions.

Continued growth in the industrial countries will support world trade growth, providing a relatively favorable environment for the developing

countries. Economic policy reform in certain of the heavily indebted countries appears likely to improve performance.

The U.S. dollar should average somewhat lower in 1990 and 1991 than during the late summer of 1989, although volatility among the industrial-country currencies should be less as a result of reduced inflation differentials. The modest fall expected for the dollar will not be enough to prevent increases in the U.S. trade and current-account deficits in both 1990 and 1991, following two years of reduced deficits. Thus, foreign purchases of U.S. financial and real assets are likely to remain strong.

Dimensions of Competition

As the 1990s begin, global economic relations are increasingly shaped by developments within and competition among three major economic powers. The unification of the economies of the 12 member countries of the European Communities (EC), targeted for completion by the end of 1992, is already having a major impact on economic policymaking and investment patterns. In the future, the EC economy will have to be viewed as a single unit rather than a collection of 12 disparate markets. In North America, the Free Trade Agreement (FTA) between Canada and the United States means that, at least in terms of merchandise trade, a larger, freer market now exists. The FTA, however, is much more limited in scope than the comprehensive market unification occurring in Europe. Japan is the third major center of economic and financial activity. Although it is not part of any formal grouping, Japan's economic relations with other Asian countries have expanded. Japan and the newly industrialized economies of East Asia are major forces in international trade.

Comparisons of Europe, North

DIMENSIONS OF COMPETITION:
NORTH AMERICA, EC AND JAPAN
 (1988, except as indicated)

	N. America	EC	Japan
Population (millions)	272.3	324.7	122.8
GNP (\$ billions)	5,335.8	4,754.6	2,858.9
GNP per capita (dollars)	19,597	14,641	23,275
Employment growth (1984-88, annual % change)	2.7	0.9	1.0
Govt. expenditures (% of GDP, 1983-87)	37.5	49.6	33.3
Fixed capital formation (% of GNP, 1984-88)	17.8	19.3	28.5
Exports (\$ billions)	272.2	425.6	264.9
Commercial-bank international assets (\$ billions)	780	1,471	1,756

America, and Japan are made in the table above illustrating some of the dimensions of competition in the 1990s. Although Europe has the greatest population, its per capita income still lags behind those of North America and Japan. Thus, when Canada is added to the United States, North America remains somewhat larger than the EC in economic size. In some industries, economies of scale will be significant in increasing European competitiveness during the 1990s.

In recent years, Japan has shown the lowest level of government expenditures in relation to GDP and, concomitantly, the highest rate of capital formation. A reduction of the role of governments in Europe is

widely considered a prerequisite for increased global competitiveness. Japan's strong foreign-trade performance has led to the accumulation of substantial foreign assets, reflected in the size of the country's international banking assets. North America ranks third in the size of its international banking activity.

Industrial Countries Buoyant

During the forecast period, economic activity in the industrial countries outside the United States is expected to remain relatively buoyant. In 1988, the collective real growth rate of the six largest non-U.S. economies reached 4.5%, its highest level of the decade. Japan, with a 5.6% rise in real GNP, was the growth leader, but the

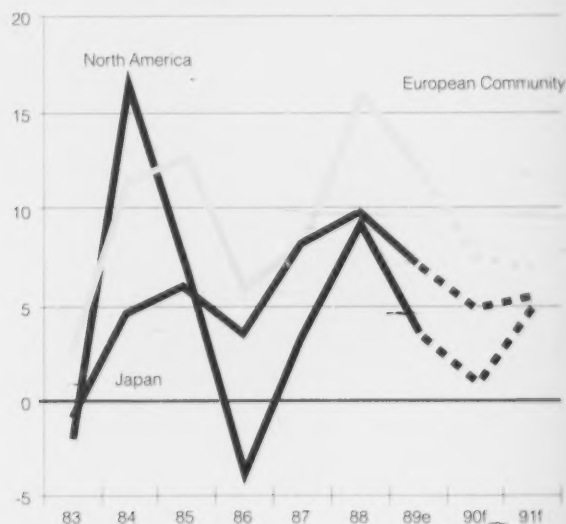
European economies and Canada also turned in sound growth performances. At the same time, inflation was quite modest in Japan and Germany, the two largest of these economies.

During 1989, growth in Japan and Germany appears to be continuing at a fairly rapid pace. The economic restructuring of Europe is providing considerable impetus to investment throughout the EC. Thus, although aggregate growth in the industrial countries will be slower than last year, the pace of economic expansion will still be higher than earlier in the 1980s. This pattern should generally continue during 1990 and 1991. The United Kingdom and Canada, however, appear likely to slow more than the other large industrial economies. Inflationary pressure, closer relations with the slowing U.S. economy, and balance-of-payments trends all indicate that monetary policy in these two countries may remain tighter than elsewhere. Overall the collective increase in real GDP in the six largest industrial economies outside the United States is likely to remain in the 3-4% range during the forecast period.

Following a "boom" in investment last year, private-sector capital formation should continue to be one of the leading growth factors during the forecast period in most major indus-

Private Investment Continues Strong

(Nonresidential fixed investment, real annual percent change)



INDUSTRIAL-COUNTRY INDICATORS

	Real Economic Growth (GDP, annual average % change)				Inflation (CPI, annual average % change)				Current Account Balance (Billions of dollars)			
	1988	1989e	1990f	1991f	1988	1989e	1990f	1991f	1988	1989e	1990f	1991f
Japan*	5.6	5.0	4.5	4.2	0.7	1.5	1.2	1.5	79.6	76.0	73.0	70.0
Germany*	3.4	3.9	3.0	2.8	1.2	2.8	2.9	2.0	48.6	51.0	47.0	43.0
France	3.4	3.0	2.4	2.7	2.7	3.7	3.9	2.6	-3.8	-5.5	-4.8	-3.0
United Kingdom	3.9	3.6	2.6	2.6	5.1	6.4	5.9	5.0	-4.0	-7.8	-8.5	-5.5
Italy	4.3	2.2	1.6	2.4	4.9	7.9	6.6	4.9	-26.1	-26.5	-23.0	-19.0
Canada	4.5	3.0	1.8	2.5	4.0	5.0	4.2	3.9	-9.1	-11.3	-12.0	-9.0
Total of above countries	4.5	3.9	3.2	3.2	2.3	3.6	3.2	2.7	85.2	75.9	71.7	76.5
G-7 (Above + U.S.)*	4.4	3.4	2.5	3.1	3.0	4.2	3.7	3.3	-41.3	-39.0	-50.6	-56.0

*GNP used for real growth

trial countries. The new dimensions of global competition are causing corporations throughout the world to revise strategies and to focus on increased productivity. Investments to take advantage of more rapid economic growth, a less regulated business environment, and economies of scale are underpinning the rise in capital formation. Producers of capital goods, such as Germany, are beneficiaries of the shift toward investment.

One factor that has affected investment decisions globally is the prospect of a unified European economy by the end of 1992. European companies and financial institutions are attempting to position themselves to compete effectively in this market, while non-EC companies are also looking at Europe as an increasingly attractive market. During the coming

two years, the approach of 1992 will continue to support a higher level of investment globally.

Another underpinning for a higher level of private investment has been lower inflation expectations and, consequently, lower interest rates. During 1989, some rise in inflation has occurred, although in most countries price rises remain moderate. In Japan, inflation should remain in the 1-2% range during the forecast period, while in Germany a 2-3% range is expected. In the United Kingdom, however, an inflationary surge in 1989 has been brought about by previously expansive monetary policy and by a lower pound. Monetary policy has been tightened, and inflation is expected to decline after this year. Similarly, moderate rises in the inflation rates in France and Italy are

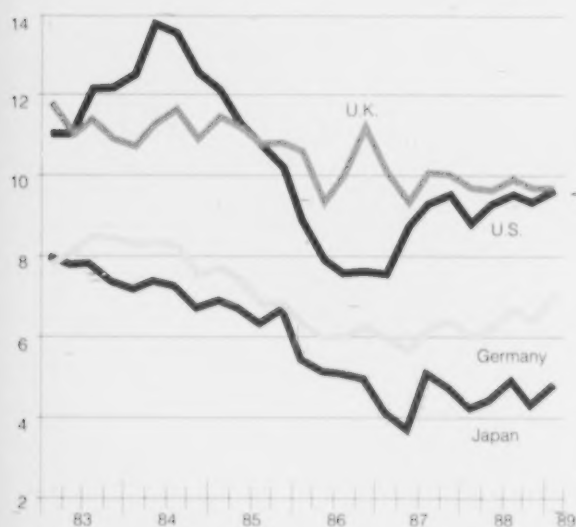
occurring, but by 1991 the rate of inflation in most countries will be back to 1988 levels.

Higher rates of economic growth have begun to bring down unemployment levels in Europe, where job creation had previously been low. The EC unemployment rate, which was 10.8% in 1986, was in the 9.0-9.5% range during the first half of 1989, and further declines are in prospect during 1990 and 1991. Nevertheless, unemployment rates in Europe remain significantly higher than in North America or Japan.

Although economic growth and inflation are tending to converge among the major countries, wide disparities in balance-of-payments performances remain. Japan and Germany continue to record large surpluses in their trade and current

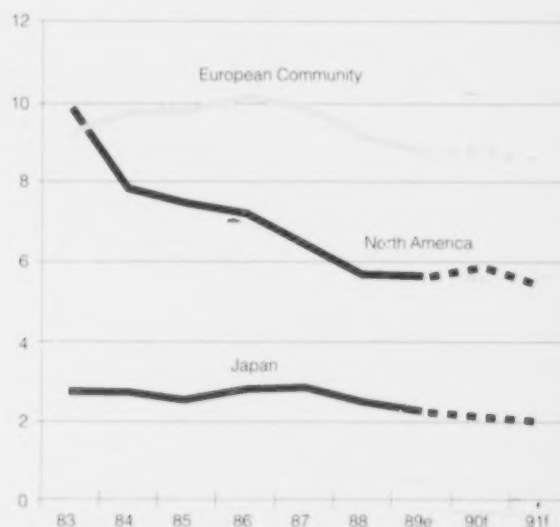
Long-Term Rates Average Lower

(Government-bond yield, percent, quarterly average)



Unemployment Steadies at Lower Levels

(Percent of labor force, annual average)



accounts, while the other large countries this year have recorded substantial deficits. In the United Kingdom and Canada, in particular, the magnitude of the current-account deficits has become a constraint on monetary policy and is one factor leading to slower growth prospects in both countries. During 1990 and 1991, both Japan and Germany are forecast to record only modest reductions in their surpluses, but the deficits of the other large industrial countries should decline.

One aspect of the continued surpluses of Japan and Germany is an increasingly strong presence by the financial institutions of those countries in global markets. As illustrated in the accompanying graph, Japanese banks have increased their presence in international financial markets at a very rapid pace during the past few years. By the end of 1988, they accounted for 38% of all international banking assets in industrial countries. Although German banks are less active on a global basis, their *net* position is even stronger. Furthermore, as European unification occurs, financial institutions in the EC will benefit from considerable economies of scale. Thus, the dimensions of competition in financial markets are being considerably altered by both deregula-

tion and balance-of-payments developments. The size of Japanese and European financial institutions is likely to continue to increase, while their cost of funds will also remain relatively low.

World Trade Expansion to Extend through 1991

World trade expanded vigorously in 1988 and continues to do so in 1989 as collective industrial-country real economic growth remains solid. The health of world trade remains a major indicator of the vitality of the world economy.

Industrial countries produce nearly three quarters of the world's exports (omitting most of the Eastern Bloc) and buy a like amount of the world's imports. Even though the developing world generates only about one fifth of the world's economic output, it supplies approximately one fourth of world exports. Nearly two thirds of developing-country exports are bought by the industrial countries.

Trade provides an important mechanism by which faster real economic growth in different parts of the world is transmitted to other parts of the world economy. During the 1980s, we have seen substantial realignments in world trade as some

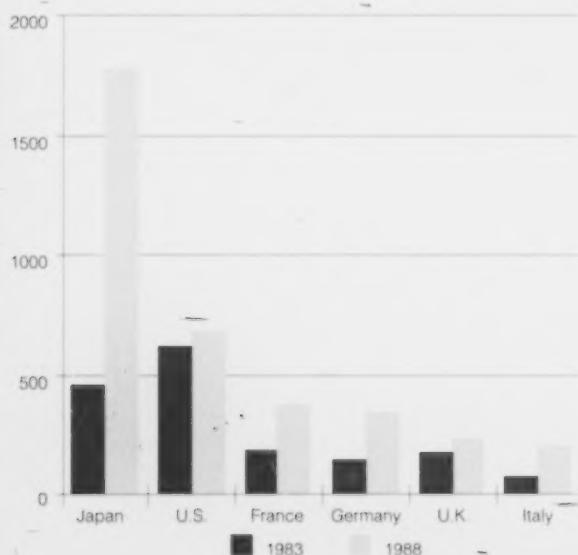
parts of the world economy have achieved higher growth than others. Developing Asia, for example, now produces about 13% of world exports, an increase from 8.5% in 1980. The Middle East's share of world imports has fallen from 12.3% in 1980 to less than 4.5%. During the same period, Africa's share of world trade has been cut nearly in half, and Latin America's share has fallen as a result of external debt and other political and economic burdens.

The volume of world trade measured by imports is recording its seventh consecutive year of expansion since the contraction of 1982. Growth of world trade has outpaced overall economic growth since the worldwide recession of 1981-82. (The industrial countries have recorded a collective real economic growth rate of 3.6% annually since 1982, while the volume of world trade has increased 6.2% per year.)

As international trade grows more rapidly than the world economy, it is a critical factor generating benefits to the consumers of the world. They are able to obtain goods produced elsewhere at lower prices. The trend toward freer trade, however, also poses risks to producers for both the export and domestic markets as others try to obtain a larger share of domestic markets or to seek a greater portion

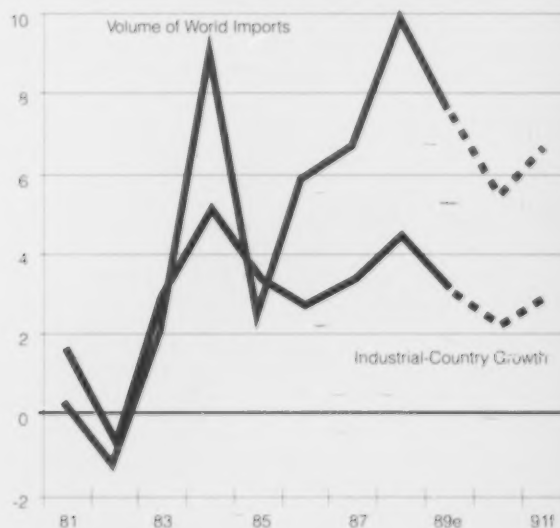
Prominence of Japanese Banks Grows

(Total international bank assets, billions of dollars)



Real Economic Growth in Industrial Countries Determines Growth of World Trade

(Annual percent change)



of the international market. What is clear is that competition in international markets has increased markedly during the past couple of decades, and this phenomenon is likely to intensify in the future.

Our forecast is for the volume (adjusted for inflation) of world trade to grow more slowly in 1990 as industrial-country growth slows and then to increase in 1991 as the world economy expands more rapidly (see accompanying graph). World trade in nominal terms should show the same pattern.

Import prices are expected to increase at a progressively slower rate in each year of the 1989-91 period. We expect that non-energy commodities will either decline in 1990 or increase at a lower rate than in 1989. Prices of non-energy commodities increased sharply in 1988, especially those for food and metals, which rose 28% and 48%, respectively. During the first half of 1989, prices increased more slowly or declined as growth weakened and additional capacity came on line. Slower industrial-country real economic growth in 1990 implies that demand for non-energy commodities will be weaker than in 1988-89, and significant additional price increases are unlikely. A modest recovery in 1991 is probable.

Petroleum prices to date in 1989

have risen from 1988 levels. For the first eight months of 1989, contract prices for West Texas Intermediate (WTI), for example, were 14% above year-earlier levels. Given that OPEC production is exceeding official quotas by a substantial margin and that other capacity is coming on line both from new development and old facilities temporarily damaged by accidents, we expect average oil prices to weaken during 1990-91 from current levels. During this period, the WTI price should average in the \$16-18 a barrel range.

WORLD TRADE

(Imports, percent change)

	Volume	Nominal
1982	-1.2	-6.3
1983	2.1	-3.0
1984	9.2	6.5
1985	2.5	0.8
1986	5.9	9.5
1987	6.6	17.5
1988	10.0	15.4
1989*	7.5	12.6
1990†	5.5	9.7
1991†	6.7	10.9

Another factor affecting import prices is domestic inflation rates, which are important for goods traded with a greater degree of processing, such as manufactured and semi-manufactured goods. Our forecast is for collective industrial-country

inflation rates to peak in 1989 and then fall in both 1990 and 1991 as these countries rein in inflationary pressures.

Better Policies to Overcome Debt Problems?

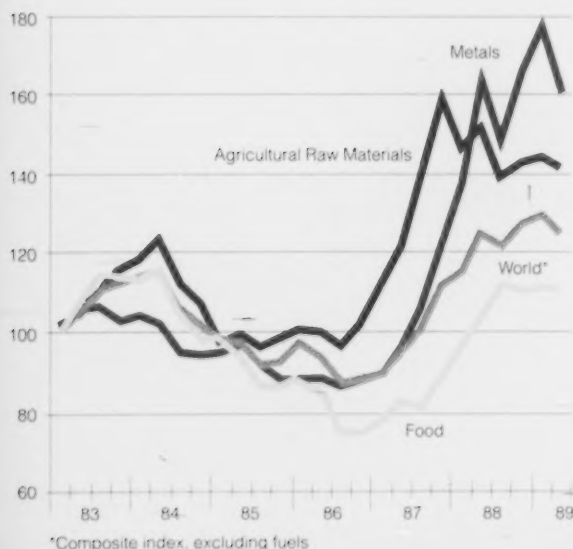
The heavily indebted developing countries appear to be moving in the direction of market-oriented policies, although the process varies across countries. In addition, a number of countries continue to suffer the legacy of past decades of statism and oligopoly. In those countries where policies are changing, however, the beginning of the 1990s may be a period of increasing economic growth and improving external-debt indicators.

Overall, global economic conditions will be relatively favorable for an improvement in the financial positions of the heavily indebted countries. In particular, lower international interest rates, fairly high rates of economic growth in the industrial countries, and a generally free-trade environment mean that developing-country exports should perform fairly well. Nevertheless, to compete effectively in global markets, maximum economic efficiency will be called for in terms of the policy environment.

As illustrated in the graph on the next page, very high inflation remains a problem in some countries where the

Commodity Price Rises Moderate

(Index, 1983 = 100, quarterly average)



reform of economic policies has still not gone far enough. Brazil, with the largest economy and the largest external debt among the countries classified as "highly indebted," continues to suffer from inflation in excess of 1,000% annually, while Argentina's efforts to cope with even higher inflation rates have only just begun. Economic growth in the highly indebted countries was barely positive during 1988.

Despite the considerable problems still faced, the realization that economic policy reform is essential to a revival of growth and longer-term development is now becoming widespread. Chilean economic policies have produced a record of fairly rapid growth, export diversification, and an improved external financial position during the past few years. Venezuela's new government has also begun to implement a new set of market-oriented policies that include privatization of some public enterprises and a reduction in trade and foreign-exchange restrictions.

For the United States, perhaps the most significant changes in economic policy are occurring in Mexico. The longer-term problems of Mexico—including inadequate social and physical infrastructure—remain

significant. Nevertheless, a major decrease in trade restrictions, partial liberalization of foreign-investment regulations, privatization of public-sector enterprises, and moves toward domestic deregulation have all occurred. In addition, the government's program to reduce inflation from earlier triple-digit levels appears to be working. Mexico's position as the third largest trading partner of the United States has been solidified as a result of rapid rises in imports and exports of an increasing variety of industrial products.

Mexico appears poised for an increase in the level of foreign investment, and economic growth will be more rapid in 1990 and 1991 than during the recent past. The restructuring of the country's foreign debt, which has been negotiated with official creditors and commercial banks, will improve the country's financial position, although foreign debt will remain a constraint on economic policymaking.

U.S. commercial banks have continued to reduce their exposure to the highly indebted developing countries. The so-called "Brady Plan," proposed by Secretary of the Treasury Brady earlier this year, gave official recognition and support to the trend of debt reduction that had already been in

place. As the accompanying graph shows, U.S. banks other than the money-center banks have actively reduced their exposure to the highly indebted countries, which has declined by more than one third during the past two years. Only the money-center banks remain significantly exposed to this problem. During 1990 and 1991, further interruptions of payments may occur in certain countries, but these situations will be manageable from a banking perspective.

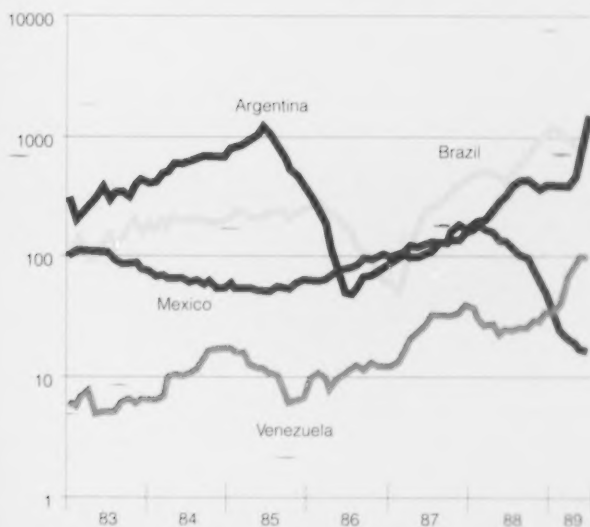
U.S. Dollar Finds Strength in 1989

Various factors combined in 1989 to keep the U.S. dollar much stronger than expected. Increasing political problems in West Germany, Japan, and then the United Kingdom enhanced the value of the dollar in relation to those countries' currencies. Continued strength in the U.S. economy also helped buoy the dollar. Even though U.S. interest rates peaked in the first quarter of 1989, their decline during the second quarter and into the third quarter did not appear to affect the market's demand for dollars very substantially.

Our forecast is for U.S. interest rates to trend downward through the second quarter of 1990. As domestic inflation rates are expected to decline

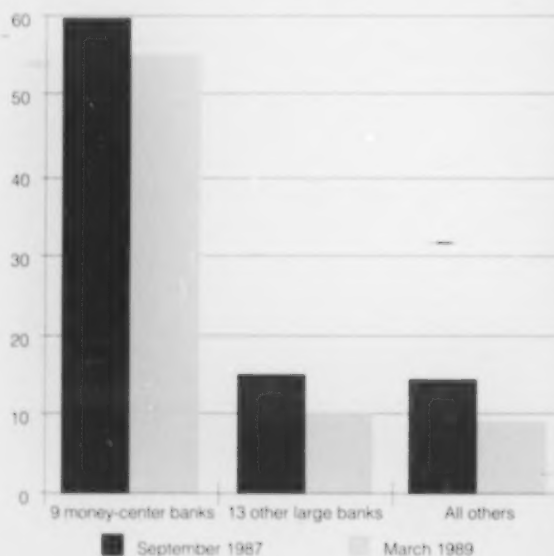
Top Four Debtor Countries Struggle with Inflation

(Monthly CPI, percent change from prior year)



U.S. Banks Reduce Developing-Country Exposure

(Loans to heavily indebted countries, billions of dollars)



more slowly, real interest rates should fall, which should lead to a lower value for the dollar generally on the foreign-exchange markets. During the second half of 1990 and through 1991, we look for U.S. interest rates to trend upward. At the same time, we expect that domestic inflation rates will decline, which implies that real interest rates will increase. Simultaneously, the U.S. trade and current-account deficits are expected to increase, but we believe that the increase in real interest rates will be more important. As the differential between U.S. and foreign real interest rates widens, the dollar should appreciate against most industrial-country currencies.

Between now and the end of 1990, elections will be held in both Japan and West Germany. A change of government in either country could lead to a weakening of that country's currency against the dollar. The currency most at risk, however, is the yen. The opposition has not governed Japan for decades. If it were to win the election in the lower house of the Japanese parliament, the yen would undoubtedly suffer against the dollar.

A series of events could lead to a weakening of the dollar. If the current government in Japan were to win the next general election and if Japan

gains increased influence in multilateral bodies at the expense of the United States, the increased use of the yen internationally would appreciate it by some degree.

It is very likely that we will see considerably less foreign-exchange volatility during 1990-91 than in earlier years. Central banks, especially the Federal Reserve, appear to be operating within narrower boundaries than earlier. If monetary policy is more stable and leads to a lower inflation rate, we should expect the dollar also to be more stable. A dollar that fluctuates less would be a great benefit to U.S. businesses in supporting trade and investment.

The main alternative to our forecast -- lower growth of the U.S. economy in late 1989 and 1990 -- would lead to a larger decline in U.S. inflation rates. A substantially weaker domestic economy would also result in a faster decline in U.S. inflation rates and in the trade and current-account deficits. Consequently, we would anticipate that the dollar would weaken somewhat more than under the baseline forecast. The dollar should not depreciate sharply as the greater decline in U.S. external deficits would partially offset the larger-than-expected fall in real interest rates. In

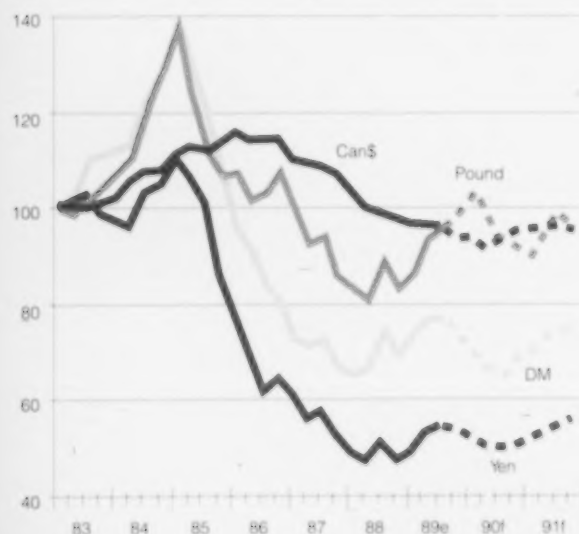
addition, concerns about foreign political developments will remain generally unaffected by the U.S. economic performance.

This dollar forecast gives little additional strength to U.S. exports and will do little to discourage imports. The forecast indicates that the dollar is likely to trade within a fairly narrow band during the next two years. If that takes place, then businesses that have made investments to produce exports that would be profitable at current levels will likely find their plans turning out to be profitable through 1991. The major threat to the forecast would be difficulties abroad that would add considerable strength to the dollar. Developments that would lead to a serious depreciation of Japanese land values and other asset values could result in a lower yen against the dollar and some substantial revisions in cross rates with other currencies.

Decline in U.S. Current-Account Deficit Stops

Our forecast for the U.S. trade and current-account deficits is that they have bottomed out in 1989 and that both will increase somewhat during the 1990-91 period. As the data in

U.S. Dollar Against Selected Foreign Currencies
(1983 = 100, quarterly average)



U.S. CURRENT ACCOUNT

(Billions of U.S. dollars)

	1986	1987	1988	1989e	1990f	1991f
Trade balance	-144.3	-159.5	-127.2	-108.3	-112.4	-118.0
Exports	224.4	250.3	319.3	367.1	400.2	433.0
Imports	-368.7	-409.8	-446.5	-475.5	-512.6	-551.0
Service balance	18.6	19.0	15.3	11.8	8.4	5.7
Service exports	148.4	174.6	210.6	230.6	249.3	267.9
Service imports	-129.8	-155.6	-195.2	-218.7	-240.9	-262.3
Transfers balance	-15.7	-13.4	-14.7	-16.3	-17.7	-19.2
Official	-14.0	-10.0	-10.4	-11.3	-12.0	-12.8
Private	-1.7	-3.4	-4.3	-5.0	-5.7	-6.4
Current-account balance	-141.4	-154.0	-126.5	-112.8	-121.7	-131.5

the table show, we expect that the 1989 merchandise-trade deficit will fall about 13% from the 1988 level. Export growth in 1989 will be somewhat more than twice import growth, but the differential has narrowed considerably from that in 1988 when export growth was nearly triple import growth.

We expect U.S. export growth to slow as most of the potential of the dollar's depreciation since February 1985 is fulfilled and growth abroad slows. U.S. exports have benefited from the appreciation of the Taiwanese and South Korean currencies and from lower barriers to imports in both of these countries. Since Taiwan and South Korea have given up some of their international competitiveness, other countries are moving in rapidly to

replace them in the more labor-intensive industries. The leading example of a newly emerging NIE (Newly Industrializing Economy) is Thailand; another is probably Malaysia. Both should be potentially good markets for U.S. exports of plant and equipment, given our forecast of the value of the dollar.

Import growth will be less strong, but several factors will support imports to a considerable extent. On a fourth-quarter-to-fourth-quarter basis, domestic real economic growth will be stronger during 1990 than during 1989 and even stronger in 1991. We do not foresee a strong depreciation of the dollar occurring during 1990-91, so pressure from the foreign-exchange value of the dollar

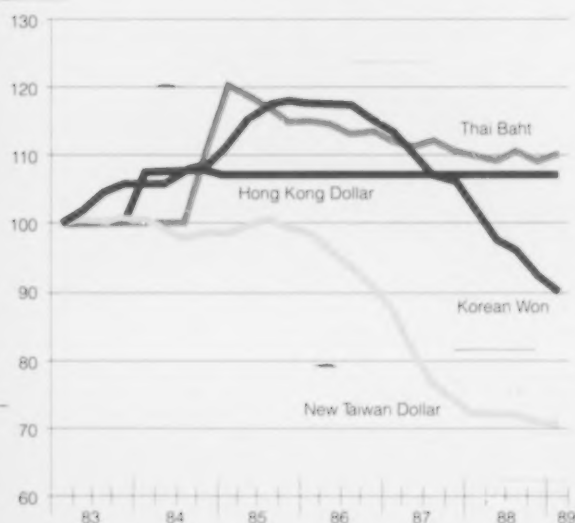
will not be a significant brake on import growth.

The current-account deficit forecast for 1990-91 indicates that the United States will have to attract an annual net capital inflow exceeding \$110 billion during the forecast period. Increased competition for U.S. firms will occur as foreign firms set up plants in the United States. In addition, the net inflow of capital will be manifested partially in the purchase of existing firms as foreign interests become more familiar with the U.S. economy. Foreign investors tend to buy U.S. Treasury assets initially, then move into equities and major real assets like buildings in large cities, and then spread into other real assets. The Japanese are now well along this "learning curve" and the Taiwanese and others are following them. Hence, foreign takeovers of U.S. companies are likely to continue or even accelerate.

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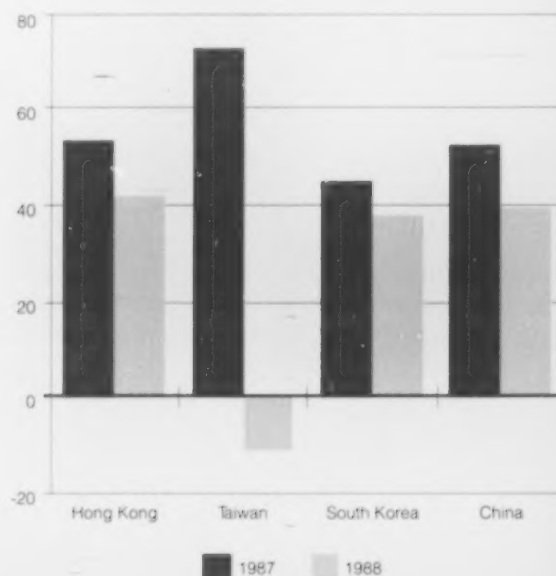
Korean and Taiwanese Currencies Appreciate

(U.S. dollar against Asian currencies,
1983 = 100, quarterly average)



U.S. Exports to NIEs Slow

(Percent change in total exports)





U.S. households and businesses will find themselves in a less volatile economic environment in the next two years. A longer term focus of monetary policy should promote greater stability, although absorption of private-sector saving by government spending and deficits will be a continued concern.

Moderate economic growth and declining inflation will characterize the next two years. After an estimated rise of 1.7% in 1989, we expect real GNP to increase 2.4% in 1990 and 2.7% in 1991. Inflation is likely to subside from close to 5% in 1989 to about 4% during each of the next two years.

Slower economic growth and lower inflation will combine to push interest rates downward into the first half of 1990. By year-end 1991, our forecast is for interest rates still to be below their peaks of early 1989.

Economic Policies — Boundaries of the Arena

Economic policies in the United States will affect the ability of American firms to compete in the global arena and partially determine the character of the economic setting. In addition, while much of the focus in the past thirty years has been on macroeconomic policies affecting overall growth and inflation, more attention will now be directed to microeconomic policies to address such problems as poor education, pollution, crime, and congestion.

Monetary Policy—A New Course?

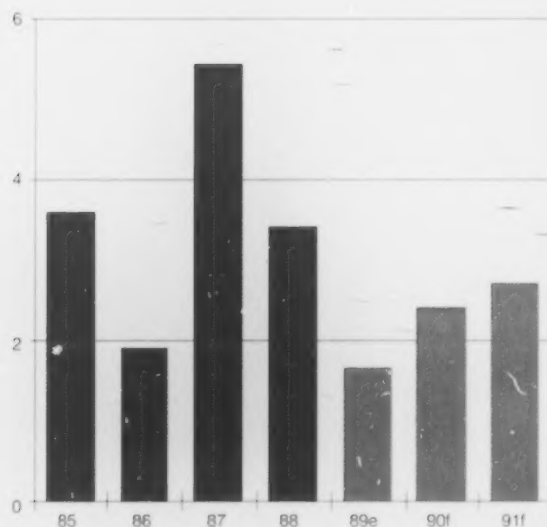
Actions by the Federal Reserve will continue as the most important macroeconomic factor affecting both American business firms and global financial markets. The basic policy agenda of the Federal Reserve remains unchanged: (1) reduce and control inflation; (2) sustain economic growth; (3) contribute to a stable dollar on foreign-exchange markets; and (4) safeguard the integrity of the U.S. financial system.

During the past two years the Federal Reserve has focused on the first of these four objectives, dampening inflation. Between the first part of 1988 and 1989 the target for the federal funds rate was raised by more than three percentage points. Money

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Moderate Pickup in Real GNP

(Percent change, 4th quarter to 4th quarter)



growth as measured by the monetary base (currency plus bank reserves) was cut in half from 6.9% in 1988 to an estimated rate of only 3.4% in 1989.

The Federal Reserve views the potential real growth of the U.S. economy as about 2.5% a year and is trying to keep growth below that pace to quell inflation. During the first half of 1989, the economy grew at an average real rate of slightly over 2%, excluding effects of the drought rebound. The Fed's goal of a "soft landing" seemed on track.

In its midyear report on monetary policy to Congress, the Federal Reserve indicated that it looks for real growth to continue in the 1.5-2.0% range in 1990. A key issue affecting the outlook for next year is whether the Fed can or will hold the economy to such a low-growth track. Two points are relevant. First, fine-tuning the economy is extremely difficult, and a tight-policy "overshoot"—tipping the economy into recession in the next several months—is a significant possibility. Second, even if the overall economy continues to post slow but positive growth, important sectors could decline. Manufacturing, now stagnating, seems particularly vulnerable.

The main assumption behind our forecast for 1990 is that a substantial

weakening in the economy in the latter part of 1989 will prompt an easing in Federal Reserve policy. This will imply both lower interest rates and more rapid monetary growth. While changes in monetary policy affect inflation with quite a long lag—about two years—accelerations and decelerations in monetary-base growth affect real economic activity relatively quickly. Consequently, we would expect the Fed to prevent any downturn in the economy from becoming deep or prolonged.

We assume that the monetary base will expand somewhat over 5% in both 1990 and 1991. This is a pace that should accommodate both moderate real economic growth and lower inflation.

Fiscal Policy—New Tradeoffs

No dramatic changes are likely in federal spending and tax policies over the next two years. The Balanced Budget Act (Gramm-Rudman-Hollings) will impose some restraint on the budget process, but the deficit targets will almost certainly be breached.

The Gramm-Rudman target for fiscal year 1990 is a deficit of no more than \$100 billion, while the deficit target for 1991 is \$64 billion. We estimate that the actual deficit for each year is likely to be in the range of

\$150-155 billion.

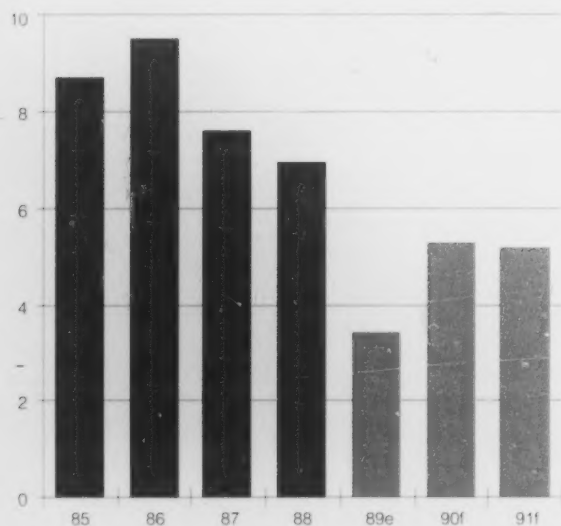
A cut in the capital-gains tax rate would likely bolster revenues, cushioning some of the impact of slower economic growth in the near term. At the same time, however, the Congressional Budget Office estimates that efforts to rescue the savings and loan industry will add about \$65 billion to net spending over the 1989-94 period (including both on- and off-budget activities).

More cuts in defense spending appear inevitable. In fiscal year 1968, the Vietnam War drove military spending in the United States to nearly 10% of GNP. After winding down to a low of less than 5% of GNP in 1979, outlays under the Reagan Administration grew to a new peak of 6.5% of GNP in 1986. That share has since declined and will likely again move back toward the 5% level by 1991.

Many candidates will compete for the "peace dividend." Education, anti-crime, and anti-drug programs will be in the forefront, as will demands to improve America's infrastructure (highways, bridges, and airports). Greater reliance on the private sector will be necessary. Allowing more competition from private education and making greater use of the price system to reduce traffic congestion and

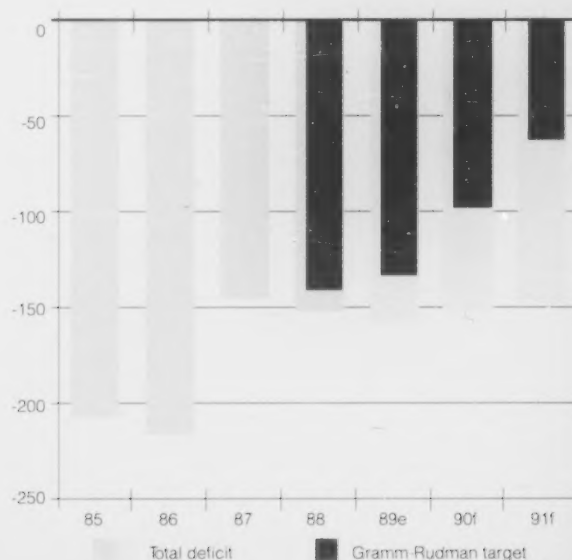
Less Restrictive Fed Policy

(Percent change in monetary base, 4th quarter to 4th quarter)



Federal Deficit Targets Missed

(Billions of dollars, fiscal year)



ease demands for new and expensive transportation systems will be important.

The implicit strategy of the Administration and Congress regarding the deficit may be to try to "grow out of the problem" and rely on offsetting surpluses in the social security fund. Too many domestic spending programs have backers to attempt a major slowing in government outlays. At the same time, little support exists for a tax increase. Nevertheless, the deficit as a share of GNP is likely to fall from an average of 4.1% in the 1980s to about 2.6% of GNP in fiscal 1991. This would be closer to the average level of the 1970s, although well above the levels of the 1960s.

Growth -- Economic Resilience

The U.S. economy is resilient and, as a market economy, has a natural tendency to grow. The economy even seemed to weather, at least through the first half of 1989, the impact of a major tightening in monetary policy. While we expect a much weaker performance in the second half of 1989, a swing to more accommodative monetary policy should allow the economy to return to a real growth rate of 2.5-3.0% by the spring of 1990.

Following an estimated gain of only

1.7% this year (fourth quarter to fourth quarter), our forecast is a rise of 2.4% in real GNP in 1990 and 2.7% in 1991. Growth during the next two years would thus be close to the 2.5% potential estimated by the Federal Reserve, but below the 3.0% rate we believe is sustainable. During the past 30 years, real GNP growth has averaged 3.1% per year.

Consumers More Conservative

Consumers in the United States appear to have moderated their spending. In 1986, real consumption outlays peaked at over 66% of GNP. During the next two years, we see consumer spending growing at a slower pace than the overall production of goods and services. This will drive the consumer spending/GNP ratio to less than 64% by the end of 1991. Several forces appear to be causing a moderation in consumer spending growth: the maturing of the "baby boom generation," an easing of inflationary expectations, and the phasing out of deductions for certain interest expenses.

Although at a more measured pace, consumer spending is still likely to expand over the next two years. Auto sales have experienced a difficult year in 1989 and have been supported mainly by costly rebate and incentive programs. In 1990, we expect a small

increase of about 200,000 cars for sales of 10.2 million. Including another sales year of 4.6 million light trucks, motor-vehicle purchases would total 14.8 million units in 1990, up slightly from this year's 14.6 million.

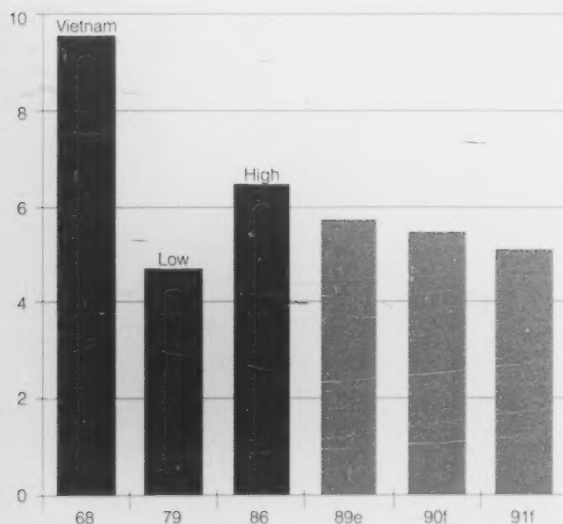
We look for total car and truck sales to reach 15.8 million in 1991, although this would still trail the 16.0 million record of 1986. By 1991, we expect the share of imports in domestic car sales to slip to 25% from the high of 31% in 1987, as foreign producers shift operations to the United States.

Housing Passes Low -- Nonresidential Sluggish

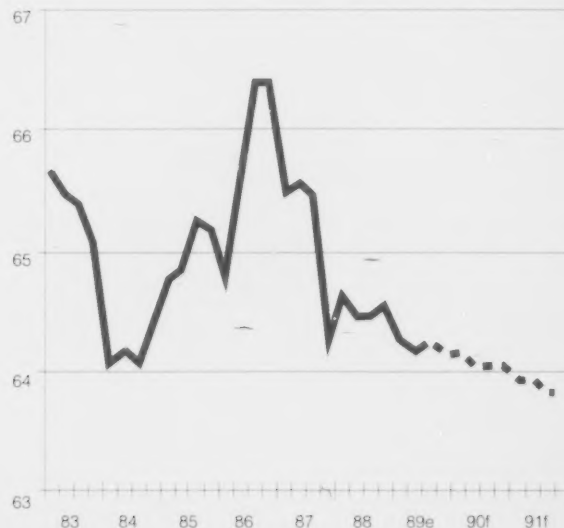
We believe that 1989 will mark the low point for the current housing cycle and that housing starts will be higher in both 1990 and 1991. The ability of financial institutions to continue to attract funds during periods of tight money, albeit at higher interest rates, has dampened significantly the amplitude of housing cycles.

If 30-year, fixed-rate mortgage rates average below 10% in 1990-91, as in our forecast, a moderate recovery in homebuilding should develop. We look for a gain of 4.7% in housing starts to a total of 1.48 million units in 1990, followed by a 5.5% increase in 1991 to 1.56 million units. Most of the gain next year will be in the single-family sector. However, by 1991 the vacancy

Defense Spending Wanes
(Defense outlays as percent of GNP, fiscal year)



Consumer Buying Spree Over
(Real consumer spending as percent of GNP)



rate in apartment buildings may be low enough in some areas to justify more construction in the multi-family segment. First-time buyers in the more expensive housing markets are also helping to revive interest in condominiums.

Nonresidential building in most markets will be constrained by high vacancy rates until 1991 or later. Projects already in the pipeline will support a substantial amount of construction, and both domestic and foreign investors will develop projects with longer time horizons. However, the dollar value of permits for nonresidential building is likely to increase by less than 2% in 1990, a showing similar to that estimated for this year. Some recovery could then develop in 1991, with a gain approaching 6%.

Investing to Compete

U.S. business firms have invested heavily during the past two years to improve their competitive position in both domestic and foreign markets. Between mid 1987 and mid 1989, outlays for capital equipment expanded at an annual rate averaging over 9% in real terms.

The slowdown that the manufacturing sector has already

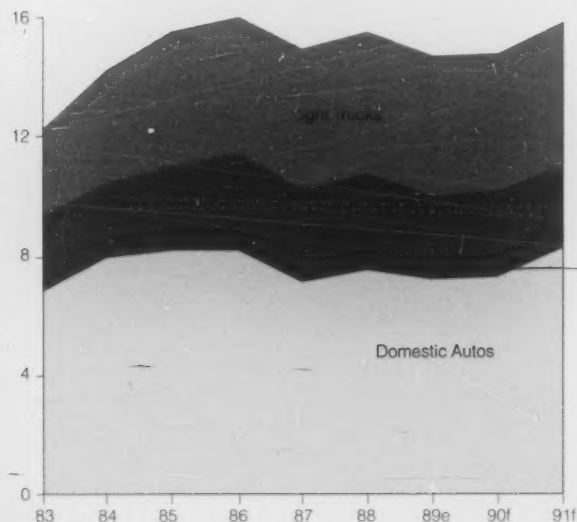
MAJOR ECONOMIC INDICATORS

	1989				Quarterly 1990			
	I	II	III	IV	I	II	III	IV
	Actual				Forecast			
GROSS NATIONAL PRODUCT (Billions of \$, annual rate)	5113.1	5203.8	5272.8	5323.3	5391.8	5485.3	5577.7	5677.1
% Change, annual rate	7.9	7.3	5.4	3.9	5.2	7.1	6.9	7.3
REAL GNP (Billions of 1982 \$, a.r.)	4106.8	4134.0	4142.2	4139.1	4150.5	4179.2	4207.2	4240.4
% Change, annual rate	3.7	2.7	0.8	-0.3	1.1	2.8	2.7	3.2
REAL FINAL DOMESTIC SALES* (Billions of 1982 \$, a.r.)	4140.6	4164.2	4172.1	4163.2	4165.9	4185.7	4211.1	4243.9
% Change, annual rate	1.3	2.3	0.8	-0.8	0.3	1.9	2.5	3.2
REAL CHANGE IN INVENTORIES (Billions of 1982 \$, a.r.)	24.5	19.0	16.8	14.0	17.5	22.5	25.0	26.5
GNP DEFLATOR (1982=100)	124.5	125.9	127.3	128.6	129.9	131.3	132.6	133.9
% Change, annual rate	4.0	4.6	4.5	4.2	4.1	4.2	4.1	4.0
CONSUMER PRICE INDEX (1982-84=100)	121.9	123.8	125.0	126.3	127.6	129.0	130.3	131.7
% Change, annual rate	5.4	6.4	3.9	4.3	4.2	4.3	4.3	4.2
AUTO SALES (Millions, annual rate)	9.8	10.3	10.4	9.6	9.7	10.0	10.4	10.7
HOUSING STARTS (Millions, annual rate)	1.52	1.36	1.40	1.39	1.42	1.46	1.52	1.55
INDUSTRIAL PRODUCTION (1977=100)	140.7	141.6	141.9	141.7	142.1	143.0	144.0	145.1
% Change, annual rate	2.3	2.6	0.8	-0.4	0.9	2.6	2.9	3.2
NONFARM EMPLOYMENT (Millions)	107.7	108.3	108.8	108.7	108.9	109.2	109.7	110.2
UNEMPLOYMENT RATE, ALL WORKERS (Percent)	5.1	5.2	5.2	5.5	5.7	5.6	5.5	5.4
CORPORATE PRETAX OPERATING PROFITS (Billions of \$, annual rate)	316.3	309.1	307.0	305.0	303.0	307.0	315.0	322.0
% Change over year ago	-0.6	-5.0	-7.2	-10.3	-4.2	-0.7	2.6	5.6
PROFITS AFTER TAXES (Billions of \$, annual rate)	173.6	164.3	162.0	160.0	158.0	161.0	168.0	174.0
% Change over year ago	8.6	-1.6	-6.5	-8.9	-9.0	-2.0	3.7	8.7
MONETARY BASE (Billions of \$, a.r.)	277.7	278.7	280.8	283.7	287.1	291.3	295.2	298.8
% Change, annual rate	4.7	1.5	3.0	4.3	4.8	6.0	5.5	5.0

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on unrounded data; a.r. = annual rate. *Excluding Commodity Credit Corp. purchases.

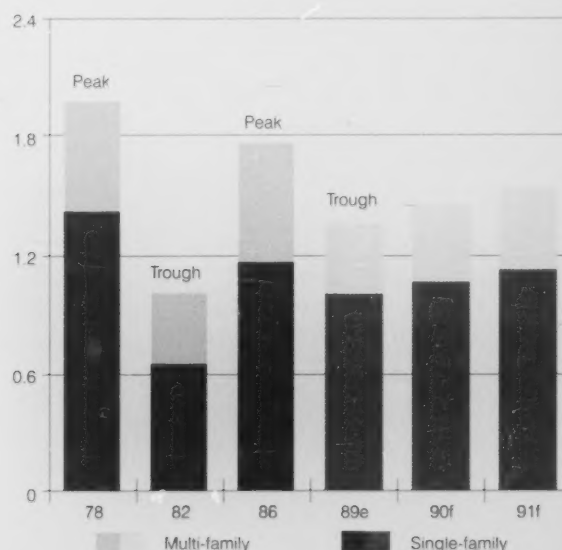
Larger Share of American-Made Cars

(Sales in millions of units)



Housing Starts at Moderate Levels

(Millions of units)



1991				4th Quarter		4th Quarter		4th Quarter	
I	II	III	IV	1989	% Change '89/'88	1990	% Change '90/'89	1991	% Change '91/'90
Forecast				Estimate		Forecast		Forecast	
5770.0	5861.6	5958.9	6054.9	5323.3	6.1	5677.1	6.6	6054.9	6.7
6.7	6.5	6.8	6.6						
4268.7	4296.2	4327.0	4357.0	4139.1	1.7	4240.4	2.4	4357.0	2.7
2.7	2.6	2.9	2.8						
4272.3	4298.2	4326.6	4355.8	4163.2	0.9	4243.9	1.9	4355.8	2.6
2.7	2.4	2.7	2.7						
27.0	28.5	31.0	32.0	14.0	N/A	26.5	N/A	32.0	N/A
135.2	136.4	137.7	139.0	128.6	4.3	133.9	4.1	139.0	3.8
3.9	3.8	3.8	3.7						
133.0	134.3	135.6	136.9	126.3	5.0	131.7	4.2	136.9	4.0
4.1	4.0	4.0	3.9						
10.8	11.0	11.1	11.2	10.0**	-5.8	10.2**	1.5	11.0**	8.0
1.56	1.56	1.56	1.58	1.42**	-4.8	1.48**	4.7	1.56**	5.5
146.2	147.2	148.4	149.4	141.7	1.3	145.1	2.4	149.4	2.9
3.0	2.8	3.1	2.9						
110.7	111.2	111.7	112.2	108.7	1.8	110.2	1.3	112.2	1.8
5.3	5.2	5.2	5.0	5.6	N/A	5.4	N/A	5.0	N/A
326.0	331.0	334.0	338.0	305.0	-10.3	322.0	5.6	338.0	5.0
7.6	7.8	6.0	5.0						
178.0	183.0	186.0	190.0	160.0	-8.9	174.0	8.7	190.0	9.2
12.7	13.7	10.7	9.2						
302.9	306.6	310.5	314.4	283.7	3.4	298.8	5.3	314.4	5.2
5.5	5.0	5.2	5.1						

**Annual total; N/A = Not applicable.

started to see and that is projected to become more generalized by the end of 1989 is likely to restrain new capital spending in coming months. Machine tool companies have already seen deferrals in new orders by the auto industry.

Various companies experiencing a squeeze on profits may delay purchases of capital equipment, such as new computers or trucks. We expect such cutbacks to be relatively short-lived, however. A return to better economic growth by next spring, along with lower interest rates, should bolster further gains in outlays to modernize facilities and improve productivity.

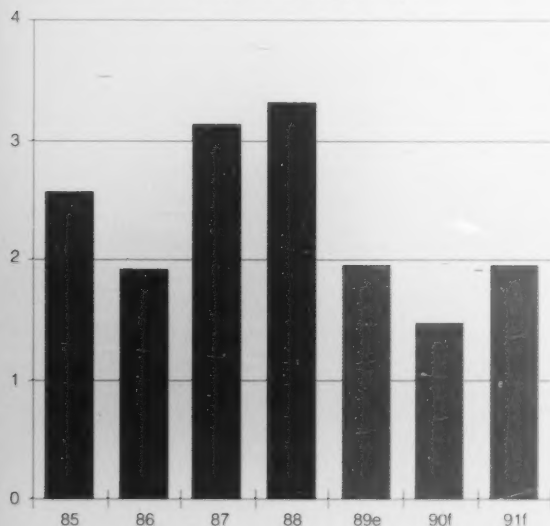
Labor Markets—Only Temporary Easing

In just the five years through 1989, the U.S. economy has generated nearly 13 million jobs, or an average of 2.6 million per year. In the next two years, we expect a still significant, but more modest, average of 1.7 million new jobs per year. This smaller number of additions to payrolls will reflect both more moderate economic growth and efforts by business firms to raise the productivity of their existing work forces.

We expect the slowing in the economy to push the jobless rate up to an average of 5.7% in the first quarter of 1990. While this will represent

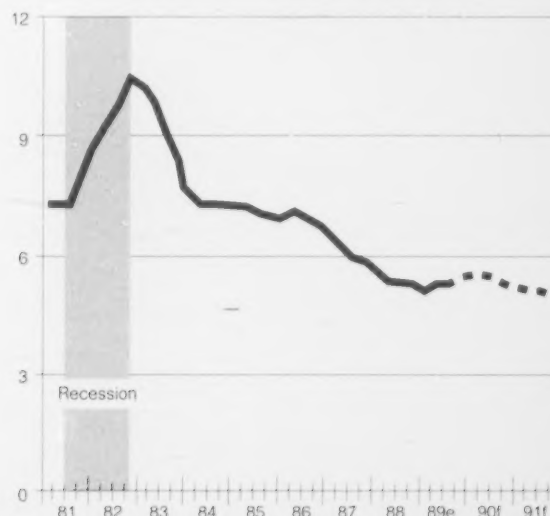
Job Boom Ebbs

(Change in nonfarm employment in millions, 4th quarter to 4th quarter)



Jobless Rate Relatively Steady

(Unemployment as percent of total labor force, including military, quarterly average)



some slack in the overall labor market, sectors and regions experiencing extremely tight situations this year are likely to see little relief. The overall jobless rate is then likely to ease to an average of 5.4% by the fourth quarter of next year and 5.0% by the end of 1991.

The quantity, cost, and quality of the work force will be major issues affecting the ability of firms to compete effectively in the 1990s. We anticipate that the work force will grow an average of only 1.2% per year during the next two years. This forecast even assumes fairly high rates of participation in the work force by women and older workers as well as relatively high rates of immigration. In contrast, the work force grew an average of 1.7% during the 1980s and 2.5% during the 1970s.

Changes in the age structure of the labor market will be important. Whereas workers aged 35-54 will have expanded by approximately 60% in the 15 years to the year 2000, the total labor force is likely to have risen by only about 20%. A more mature and experienced work force could bolster productivity and is likely to be a more stable group with lower turnover.

However, these employees are also likely to demand more comprehensive benefits and greater responsibilities.

During the next few years, the number of younger workers aged 16-34 will shrink. These have typically been the "entry-level" workers receiving lower wages. Retailers, service firms, and manufacturers will find it necessary to invest in new equipment to partially substitute for labor, boost productivity, and contain labor costs.

Inflation Outlook Brightens

We believe that inflation peaked in the second quarter of 1989 and will head lower through 1990 and 1991. Consumer prices soared at an annual rate of 6.4% in the second quarter and are likely to be up 5.0% for the full year (measured fourth quarter to fourth quarter). In 1990, we expect prices to be up 4.2%, followed by a rise of 4.0% in 1991.

Inflation remains essentially a monetary phenomenon. Its basic cause in every country is the expansion of the money supply at a rate more rapid than a nation's increase in the output of goods and services. What is the appropriate measure of the money supply? Both our own research and work done at the Federal Reserve suggest that, in the United States, M2 (currency, checking, savings, and small time deposits) is the best long-run predictor of changes in prices.

To gauge the pressure on prices,

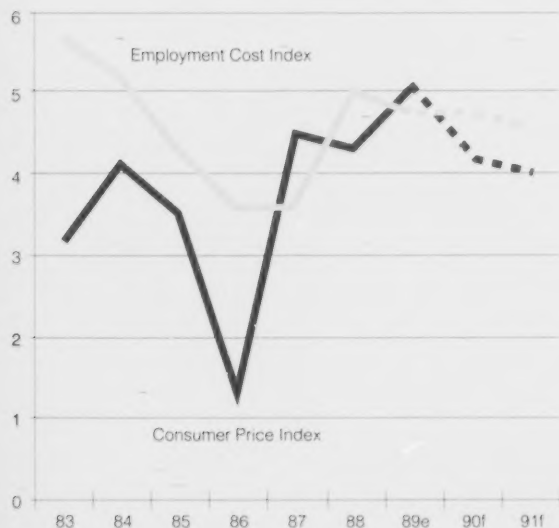
the Federal Reserve uses 2.5% as the measure of real potential growth and subtracts that from the growth rate of M2. Although the lag between accelerations and decelerations in money and prices can vary, we find that the typical lead time is about eight quarters. With M2 growth this year likely to be less than 4%, subtracting 2.5% for potential growth (a number we believe is conservatively small) implies an inflation rate for 1991 of less than 2%. While inflation is unlikely to be that low, the impact of monetary policy clearly will be to dampen the rise in prices.

Supply shocks can have a short-lived but substantial impact on prices. Large increases in both food and energy prices contributed to the run-up in consumer prices in the first part of 1989. However, by the middle of the year, we had already started to see the unwinding of those price rises. Larger crops in the United States this year should help to moderate food price increases in the coming year, while energy prices are expected to stabilize or trend slightly lower through 1991.

Widespread concern exists that a low rate of unemployment will push wages upward and contribute to higher inflation. Wage increases, however, are not a cause but rather a result of the same monetary force pushing up

Inflation Peaked in 1989

(Percent change, 4th quarter to 4th quarter)



Money Growth Points to Lower Inflation

(Quarterly, percent change over year ago)



FORECAST OF INTEREST RATES

(Quarterly averages)

	1989				1990				1991			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term	Actual				Forecast							
Fed Funds (Overnight)	9.44	9.73	9.03	8.21	7.47	7.47	7.69	7.87	8.04	8.19	8.32	8.44
Treasury Bills (3-month) ¹	8.54	8.41	7.86	7.05	6.50	6.48	6.70	6.92	7.10	7.25	7.38	7.50
CDs (3-month, secondary)	9.60	9.58	8.73	8.00	7.46	7.49	7.75	7.97	8.15	8.30	8.43	8.55
Eurodollar (3-month)	9.69	9.66	8.79	8.07	7.55	7.58	7.84	8.06	8.24	8.39	8.52	8.64
Prime Rate	10.98	11.36	10.68	10.00	9.42	9.08	9.50	9.55	10.00	10.00	10.00	10.25
Long-Term												
U.S. Government Bonds (30-yr) ²	9.04	8.71	8.09	7.97	7.83	7.83	7.88	8.00	8.05	8.10	8.15	8.20
Corporate Aaa (Moody's)	9.69	9.49	8.97	8.86	8.71	8.70	8.72	8.81	8.84	8.88	8.92	8.97
Mortgage Rate (Fixed) ³	10.80	10.67	9.96	9.83	9.67	9.67	9.72	9.84	9.89	9.94	9.98	10.04

(1) Bank discount basis (2) Yields adjusted to constant maturities (3) Contract rates on first mortgages, conventional market

prices of all types of goods and services. Average employee costs are likely to rise by about 4.8% this year and next, but 4.6% in 1991.

Employee compensation is thus likely to rise slightly faster than consumer prices in the next two years, a more normal relationship allowing real gains in workers' earnings. Employers and employees will see an increase in the social security tax rate on January 1, 1990, from 15.02% to 15.30%. Health care costs are also likely to continue to rise at a rate of 7.8% during the next two years.

Whereas the conventional wisdom is that firms will simply raise prices to cover higher employee costs, monetary

policy is unlikely to be sufficiently accommodative to permit that kind of automatic "pass through." Most firms will either experience some adverse impact on profits or find ways to hold down the rise in labor costs by limiting new hiring or improving productivity.

Interest Rates Off 1989 Highs

Just as inflation peaked in the first half of 1989, interest rates reached their cyclical highs during that time. Both short- and long-term rates, measured in terms of yields on three-month Treasury bills and 30-year Treasury bonds, reached their highs in March. Interest rates are expected to move lower through the spring of next

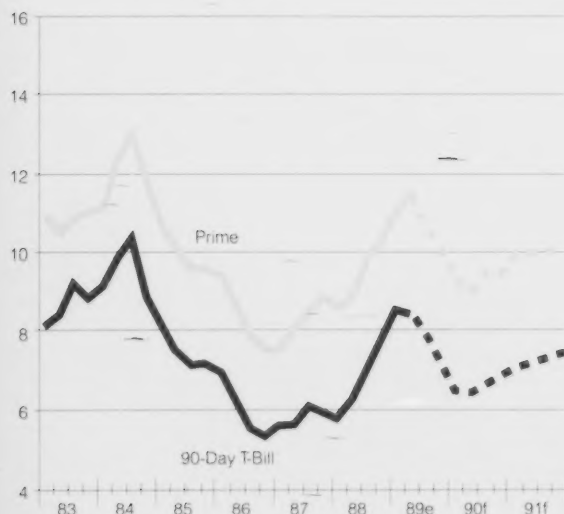
year and then move gradually upward through the end of 1991. However, even at the end of 1991, interest rates are unlikely to match the levels recorded in the first part of 1989.

Most of the movement in interest rates during the next two years will be in instruments with shorter maturities. Three forces are especially important in determining the course of short-term rates: (1) the pace of economic growth; (2) the rate of inflation; and (3) the growth of bank reserves.

Signs of slower economic growth push interest rates lower through weaker credit demands and expectations of easing on the part of the

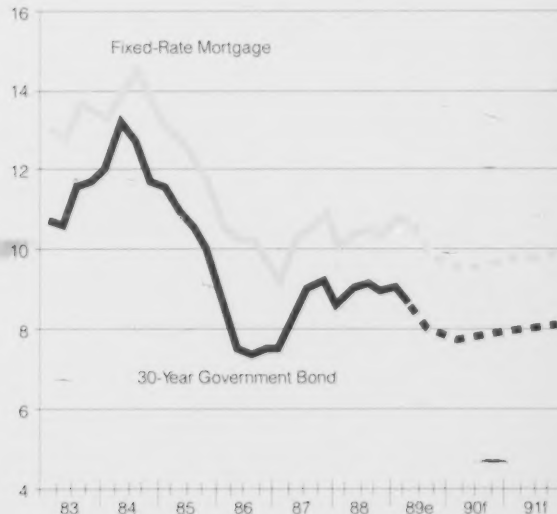
Short-Term Rates Reach Trough in First Half 1990

(Percent, quarterly average)



Long-Term Rates Stabilize

(Percent, quarterly average)



Federal Reserve. Lower inflation reduces the inflation premium in interest rates and also leads to expectations of a relaxation of monetary policy. An easing of monetary policy, in terms of more rapid growth of bank reserves, also has some short-term liquidity effect in pushing interest rates downward.

The climb in short-term rates between early 1988 and early 1989, a rise prompted largely by Federal Reserve actions, appears much larger than justified by the pace of economic growth and inflation. Consequently, we believe that a significant reduction in short-term rates will take place in the latter part of 1989 and first part of 1990. The Federal Reserve will probably have to allow short-term rates to fall in order to revive monetary growth and prevent a substantial economic downturn. A return to higher economic growth by the second quarter of next year is then likely to cause a gradual new upward trend in short-term rates.

Our specific forecast is for short-term rates to drop about 1.5 percentage points by the spring of 1990 from their recent levels. This would take rates on 3-month Treasury bills from about 8% in the summer of 1989 to an average of 6.5% in the first half of 1990. By the fourth quarter of 1991,

Treasury-bill rates would then have risen about one percentage point to an average of 7.5%.

We expect the bank prime rate to drop from its summer 1989 level of 10.5% to as low as 9.0% by the middle of 1990. By the end of next year, it would likely be about 9.5% and then at 10.0% through most of 1991. In contrast, the prime reached a peak of 11.5% in the spring of 1989.

Although long-term interest rates tend to move in the same direction as short-term rates, the magnitude of their change is likely to be much smaller than that of short rates during the next two years. This is because of the greater impact of inflationary expectations on yields of long-term assets and the "stickiness" of those expectations.

We expect the yield on the benchmark 30-year government bond to stay within a range of about 50 basis points above and below 8%. Investors need to become much more convinced that inflation in the long term will run significantly below the 4.8% average (consumer prices) of the past 30 years before accepting much lower returns.

Following the pattern of short-term rates, long-term bond yields are likely to drift lower through the middle of 1990 and then move gradually higher. This would result in 30-year govern-

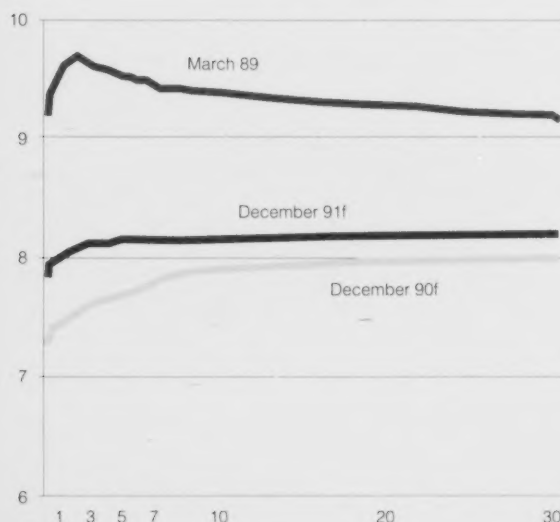
ment bond yields moving from an average of 8.1% in the third quarter of 1989 to an average of 7.8% in the first half of 1990 and 8.2% by the end of 1991.

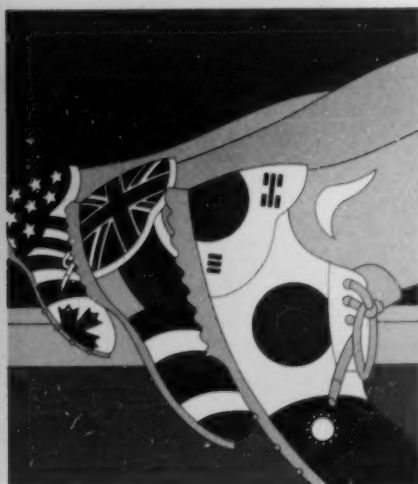
Rates on 30-year fixed-rate mortgages will continue to be highly sensitive to changes in long-term government bond yields. Consequently, we expect mortgage rates to average slightly below 10% during the next two years. In terms of the specific pattern, we look for mortgage rates to move from 10.2% in late August 1989 to an average of 9.7% in the first half of 1990. Mortgage rates then would move slowly back to the 10.0% level by the end of 1991.

Efforts by the Federal Reserve to push short-term rates higher culminated in a flat, and even inverted, yield curve (with short-term yields above long-term yields) during much of 1989. The faster decline of short-term relative to long-term rates should produce a more normal, positively sloped curve by the end of 1989 or first part of 1990.

The 1990s show promise of being a decade with much smaller swings in interest rates than experienced during the 1970s and 1980s. The Federal Reserve's commitment and the public's support to reducing and controlling inflation will be key to this result.

Yield Curve Shifts Lower
(Monthly average, bond-equivalent yield)





Export-oriented manufacturers, especially in industries that have reduced costs substantially in recent years through investment in efficient plant and equipment, are performing well and can be expected to maintain real growth over the next two years despite more moderate economic growth in 1990. Some segments, including commercial aircraft and basic industries such as chemicals, paper, and metals, could do quite well, while service-sector and construction businesses will bear the brunt of a slower economy until the second half of 1990 or 1991.

Energy prices are not expected to move beyond the range experienced in the past three years. We therefore do

not anticipate a resurgence of domestic oil and gas exploration and production; neither do we expect industries that are heavy energy users to confront rapidly escalating energy costs during the forecast period.

Industry: A Manageable Slowdown

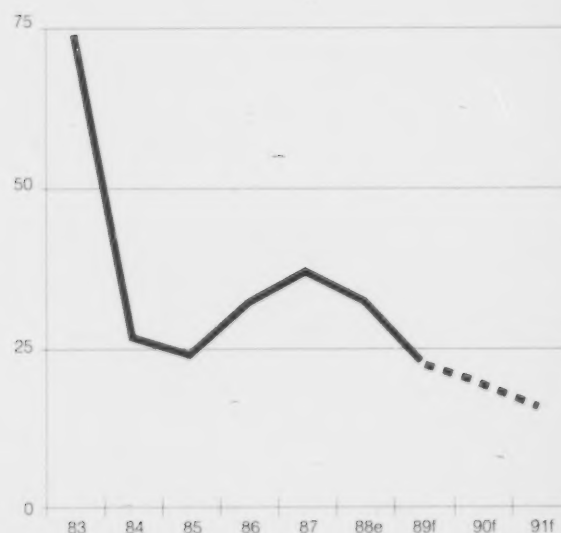
Although 1989 has proven stronger than we had expected a year ago, the slowdown from 1988 is apparent in several industries, particularly automobiles and segments of retail trade. Cyclic industries such as consumer durables and housing have experienced weaker sales and profits. At the same time, industries that are less cyclic and those oriented toward export markets have continued to grow. These trends are likely to continue before a more general recovery gets under way.

Many U.S. smokestack industries have undertaken extensive changes that leave them somewhat smaller and much more efficient relative to foreign competitors. These "leaner and meaner" industries are probably better positioned to manage during the slowdown we are expecting into the first part of 1990, particularly because of the continued large role played by export markets. In many cases, break-even operating rates are now lower, permitting continued production and less dislocation in the face of softer demand.

The coming decade will be dominated by competition that is global in scope and characterized by sizable rates of growth and change. Only

Farm Sector Less Dependent on Government

(Government payments as percent of net farm income)



moderate growth in 1990, however, will test many firms as they prepare for later recovery and a generally more prosperous decade of the 1990s.

Agriculture Outlook Positive

The U.S. Department of Agriculture outlook for crops and livestock for the next two years is generally positive, with constant or higher expected prices for broad categories of farm products, including many grain crops and meat and related products.

An important factor possibly boosting agriculture demand may be the troubled state of the economies of China and the USSR. The Soviets, assuming they are able to secure financing, may turn to the United States and other Western democracies as a source of food and fiber while they struggle with economic restructuring. While the farm export outlook is generally positive, continuing debt problems in the lesser developed countries will restrain potential export shipments of farm products.

Governments historically have provided special assistance to agriculture, but we are seeing a trend away from subsidies and protection for farm products. Within the United States, recent years have witnessed a declining government role in providing farm income, as illustrated in the accompa-

nying graph. We expect this trend to continue, partly because of budget limitations and because the reduction of such subsidies is a priority item in trade negotiations.

Lumber and Wood Products Gain from Export Market

Lumber and wood products have seen small declines in 1989, reflecting the overall economic slowdown. The housing decline hurt, of course, but lumber demand is increasingly supported by exports and the market for repairs and alterations. High timber costs in the Pacific Northwest, due in part to federal harvest limitations, have shifted output from Oregon and Washington to the southern pine region. Nationally, paper production has been stable, with higher prices inhibiting growth in volume.

As the economy expands in the early 1990s, demand for wood and paper should also rebound. Housing activity will be a plus for the industry, but the recent growth in exports will be hard to match. Paper mills are adding capacity as fast as possible, so output should soon be able to expand at a more rapid pace.

Energy Prices Could Drift Downward

The domestic production of oil will continue to decline—barring a sus-

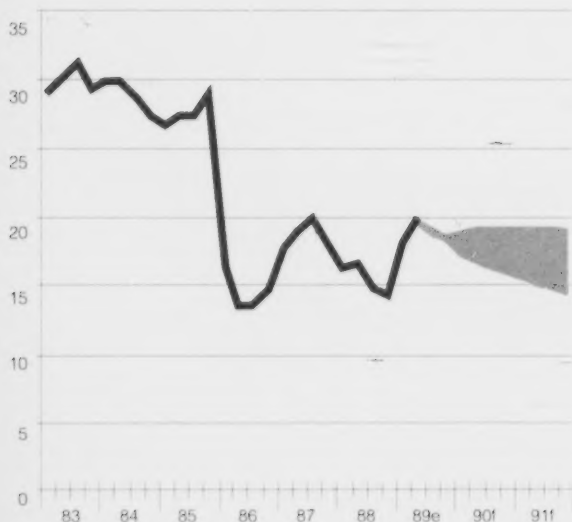
tained increase in world crude oil prices, a development we think is possible but not very likely in the next decade. Although world energy demand during the last two years appears stronger than in 1987, without substantial reductions in output from the member nations of the Organization of Petroleum Exporting Countries (OPEC) the market-clearing price of oil is likely to remain in the range experienced over the last three or four years.

For purposes of forecasting, we focus on the price of West Texas Intermediate (WTI) crude oil, which is widely traded on a spot as well as a contract basis and for which there are active futures and futures-options markets in the United States. Through the end of 1991, we expect this benchmark crude price to average between \$16 and \$18 per barrel, slightly below levels prevailing in September 1989 but in line with prices quoted on WTI futures for next year.

Our outlook for oil prices does anticipate continued increases in energy demand among the developed countries. It is our belief, however, that expanded production among OPEC member nations will be sufficient to offset demand growth, with some decline in price probably needed to clear markets. While a major price drop is possible within the next two

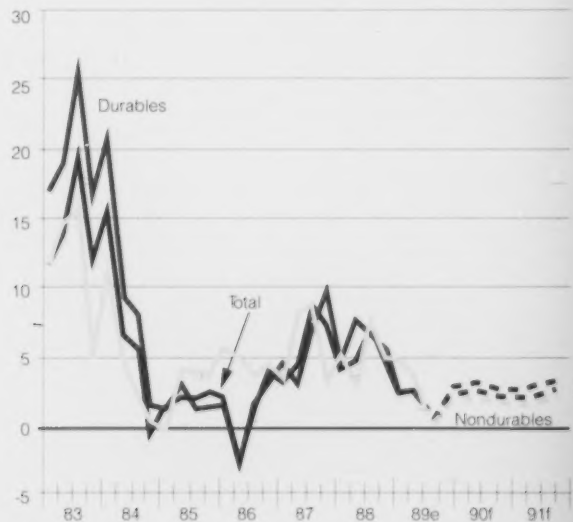
Oil Prices Should Trend Lower

(West Texas Intermediate crude oil spot price, quarterly average, \$/barrel)



Industrial Production Growth Will Dip in Near Term

(Percent change from prior quarter, annual rate)



years, we would not expect a price below \$14 would be long sustained; similarly, we think prices much above \$20 before the end of 1991 are likely to set up corrective market responses.

In our forecast graph, we attempt to suggest the increasing uncertainty attached to future price levels by showing an increasing spread between likely high and low forecast limits. Prices of other crudes would be expected to move more or less in line with WTI prices, although the differentials among crudes are themselves variable.

—Despite the fact that delivered natural gas prices for most residential and commercial users remain subject to state regulation, the process of decontrolling field prices will be completed by the beginning of 1993 as the result of legislation signed into law this year. Full decontrol will increase the efficiency of natural gas markets, potentially expanding the ability of gas to compete with other fuels—primarily oil and coal—in industrial markets. —On the whole, this will benefit both gas consumers and producers, narrowing the difference between field and delivered price. On its face, the new decontrol legislation will permit some (regulatory) categories of gas to increase in price; at the same time, the effective supply of gas will rise,

reducing the market-clearing price of marginal supplies. Finally, price deregulation will remove a major impediment to growth of industrial gas markets, thus boosting gas demand. On balance, we think natural gas prices will tend to move more closely with oil products (residual and fuel oil), though with substantial lags.

Manufacturing: Investment Goods to Lead

Industrial production, as gauged by the Federal Reserve Board Index, is expected to decline in the last quarter of 1989 before resuming modest growth in both 1990 and 1991. Because global competitive pressures and opportunities will boost durable-goods demand, we expect the production of durables to grow somewhat faster during the recovery than nondurables production, as suggested in the accompanying graph. Similarly, domestic investment and export demand will tend to favor sectors such as business equipment over consumer goods, both in the next two years and longer term.

At present, factories in most industries are running near normal capacity, with net capital investment roughly balancing output growth. As the economy slows through mid 1990, capacity utilization will dip, recovering to current levels by next year's third

quarter as suggested in the nearby graph.

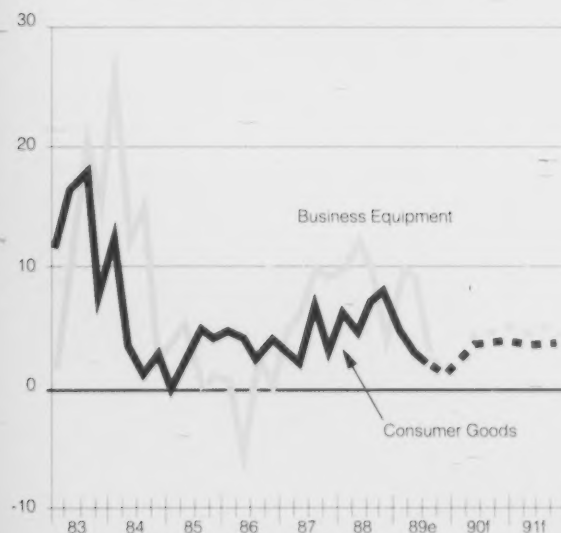
With capacity utilization more or less stable, producer prices can be expected to moderate from the 6.7% increase of the second quarter of 1989 to the 5-6% range through the end of 1991. Our forecast graph suggests that prices of capital equipment are likely to show lower increases than the total producer price index for prices of industrial commodities.

Exchange-Rate Factors

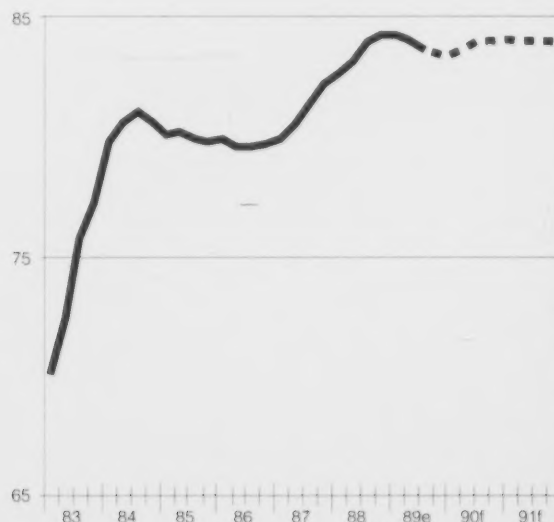
Of particular interest to domestic manufacturing is the impact of exchange-rate changes. The relative significance of such changes among industries depends on several parameters, including the degree of substitutability between domestic and foreign goods, demand elasticities, and the ratios of exports to production and of domestic to world consumption. The accompanying table, adapted from research published by the Federal Reserve Bank of Dallas, summarizes the net effect of these factors for each of several manufacturing industries.

Values in the table are meant to provide an indication of how responsive each industry tends to be to a proportionate change in all exchange rates. For example, a 10% fall in the value of the dollar is estimated to induce a 3.6% increase in the produc-

Business Equipment Will Outpace Consumer Goods Production
(Percent change from prior quarter, annual rate)



Capacity Utilization Stabilizes
(Quarterly average, percent)



EXCHANGE-RATE SUPPLY ELASTICITIES FOR U.S. INDUSTRIES

Industry	Exchange-Rate Elasticity
Miscellaneous manufacturing	.40
Leather	.37
Transportation equipment	.36
Apparel	.33
Instruments	.26
Electronic equipment	.25
Chemicals	.22
Nonelectrical machinery	.19
Furniture and fixtures	.17
Rubber and plastics	.16
Fabricated metals	.16
Primary metals	.14
Lumber and wood	.13
Stone, clay and glass	.13
Paper	.11
Petroleum and coal products	.10
Tobacco	.08
Textiles	.07
Food and kindred products	.06
Printing and publishing	.04

Source: Federal Reserve Bank of Dallas

tion of transportation equipment. On the other hand, the same decline in the dollar would induce only about a 1% increase in paper production.

Wholesale and Retail Trade Under Pressure

The slowdown in economic growth has been very apparent in retail trade (see graph). Inflation, of course, tends to boost retail sales; constant-dollar sales

are a better indication of the health of the business. As the graph suggests, there has been little growth in constant-dollar sales figures for the last three quarters, and the situation is not likely to improve dramatically. Even with higher growth in 1991, we expect retail sales in real terms to rise at a less than 3% annual rate, putting less efficient, higher-cost firms at considerable risk of failure.

Uncertain Outlook for Health Care

While we expect continued growth in health-care revenues and employment throughout the forecast period, the industry is becoming increasingly at risk of further government intervention.

For some time now, private industry has struggled to slow the rise of health-care costs, some of which can be traced to the advantageous tax treatment of medical benefits in employment compensation and the attenuation of individual incentives to limit insured expenses. Cost-control strategies have included, among other things, utilization review procedures, higher copayment rates, health maintenance organizations, and preferred-provider plans.

Despite cost-reduction efforts, price increases and growing demand for care

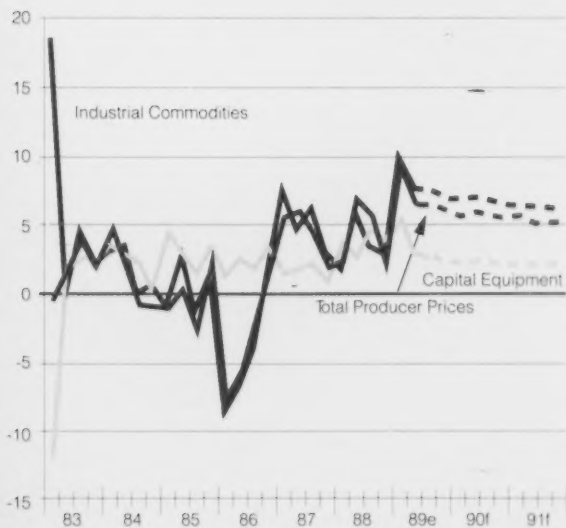
continue to boost the cost of care. Various measures are being considered in Congress to "contain" cost increases even as other proposals aim at expanding health insurance coverage. Care providers, including hospitals and physicians, may see the federal government further regulating services and compensation.

Industry Restructuring Continues

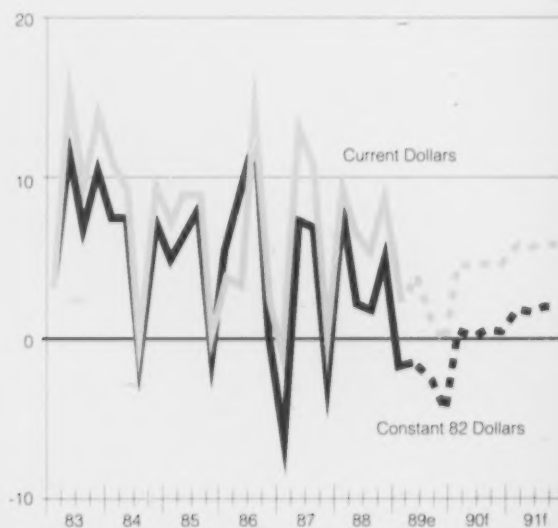
The temporary lull in merger and acquisition activity experienced in the wake of the October 1987 shake-up in world equity markets has given way to a new round of corporate takeovers and restructurings, with several examples in the fields of airlines, retail merchandising, communications, and pharmaceuticals.

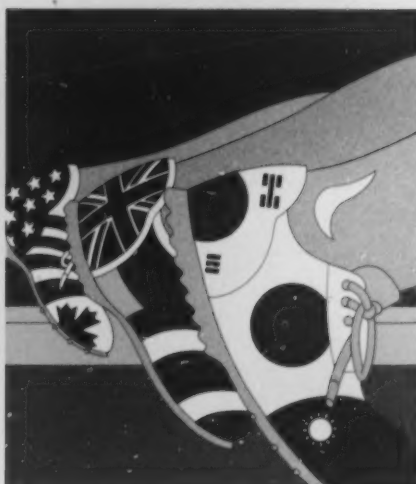
Notwithstanding the risk associated with high debt-servicing costs in leveraged transactions, the most important results of successful reorganizations are firms better suited to survive in the competitive global marketplace. In essence, firms either restructure internally to become or remain efficient, or it becomes profitable for outsiders to acquire control and undertake changes. This process of "rationalizing" the lines of business and financial structure is expected to continue at least into the early 1990s.

**Capital Equipment Prices to Rise
Less Than Other Producer Prices**
(Percent change from prior quarter, annual rate)



**Retail Sales to Show Little Improvement
in Real Terms**
(Percent change from prior quarter, annual rate)





Financial institutions and credit markets in the United States will be challenged in 1990-91 to prepare for more intense competition from their European rivals, as "Europe 1992" becomes a reality. The resultant changes in the global competitive marketplace are likely to require banks and other financial companies to be more efficient, better capitalized, and more innovative in meeting the demands of customers.

The new savings and loan rescue plan, with its emphasis on tougher capital standards, is expected to accelerate the consolidation of the thrift industry through the closing and merging of hundreds of institutions, as well as acquisition of S & Ls by

banks and other investors. To minimize the possibility of future major losses in the industry and resultant burdens on taxpayers, efforts will be made to reform the federal deposit insurance system.

The U.S. saving rate is forecast to trend higher in 1990-91 in response to demographic changes as well as changes in the consumption/saving performance of American households. A higher saving rate will help to make the United States less dependent on foreign capital in the 1990s. Some caution is warranted with respect to the rapid escalation of junk-bond financing of leveraged buyouts, especially in view of the projected slowdown in U.S. economic growth in late 1989 and early 1990.

EC 1992—Challenge for U.S. Banks

"Europe 1992," the European Communities' plan to integrate the economies of their 12 member nations into a single market, is one of the more powerful forces that will affect the competitive strategies of large U.S. banking organizations in 1990-91. The European Commission in Brussels seriously considered adopting a reciprocity rule to govern the activities of American and other non-EC banks in Europe. Such a decision would have put the European subsidiaries of American banks at a severe competitive disadvantage in the securities field due to Glass-Steagall restrictions. Reconsideration, however, led to a directive adopting the "equal national treatment" rule, which espouses functional parity for most non-EC banks in Europe.

The heightened global competition stemming from the approach of European unification will spur further deregulation of the U.S. financial structure. "Universal banking"—combining banking, insurance, and securities activities—is already a practical reality in France, West Germany, and the Netherlands, and, to an increasing extent, in Belgium and Spain. In the United Kingdom and Canada, financial restructuring towards the goal of universal banking

has also advanced in recent years. Of the major industrialized countries, only the United States and, to some extent Japan, are still lagging, as banks in both countries continue to be burdened with archaic and anti-competitive laws and regulations that perpetuate inefficiencies.

In order to prepare for increased global competition, large U.S. banks will place greater emphasis in 1990-91 on improving the credit quality of their loan portfolios and strengthening their capital positions. As the accompanying graph shows, nonperforming loans at all U.S. banks are estimated to have declined for the second year in a row—falling from their 1987 peak of \$63 billion to \$50 billion by end-1989. This reflects some relief from problems with Third World debt as well as problem agricultural, energy, and real estate loans.

Capital Standards—New Rules

The globalization of the financial services market, concerns about systemic risk to the international financial system from bank failures, and the steady downward drift of capital/asset ratios have prompted the adoption of risk-based capital standards by the 12 signatory nations of the Basle Agreement. Indeed, equity capital/asset ratios for U.S. banks

declined from 8.1% in 1960 to 6.6% in 1970 and further to 5.8% in 1980. In 1988-89, this ratio has fallen even more to about 5.0% for the very largest banks (assets over \$20 billion), although it has moved up slightly to about 6.5% for banks with assets under \$20 billion.

The new 8% standard—to be phased in by 1992—may help to reduce failures. In the United States, the failure record has become increasingly worrisome, with 200 banks failing in 1988—113 in Texas alone. This was the largest number in the 55-year existence of the Federal Deposit Insurance Corporation (FDIC), which recorded its first-ever annual loss of \$4 billion. With over 1,400 banks still on the FDIC “problem list” at end-1988, failures are likely to reach 225 in 1989. In 1990-91, the number of bank failures is likely to decline.

The new capital regime: (a) could influence how banks perceive their own risk aversion in order to maintain a high return on equity (ROE); (b) would handicap U.S. banks relative to foreign banks as the former are subject to greater government restrictions; and (c) could cause banks to focus unduly on compliance with regulations rather than on serving their markets. The pro-regulation constituencies contend that these costly and compli-

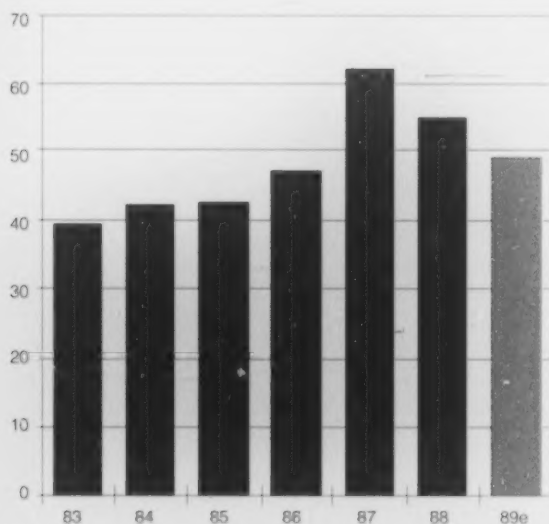
cated regulations are justified as the price that must be paid to ensure safety and soundness and to minimize systemic risk to a fragile global financial structure.

Under the new rules, the principal measure of performance is likely to become ROE, while ROA (return on assets) is likely to be a less important measure, since bank managements are less likely to emphasize asset expansion and pay more attention to balancing risk against return. ROE for all U.S. banks in 1988 rebounded to 13.7% from a dismal 1.5% in 1987. In 1987, the profits of large multinational banks were severely depressed by special LDC loss reserve provisions. For banks with assets over \$1 billion, the improvement was even more dramatic, from -2.8% in 1987 to 16.5% in 1988. The largest banks are likely to better this performance in 1989, with ROE averaging close to 20%. If this ratio can be maintained in the high teens in 1990-91, U.S. banks would be well-positioned to compete.

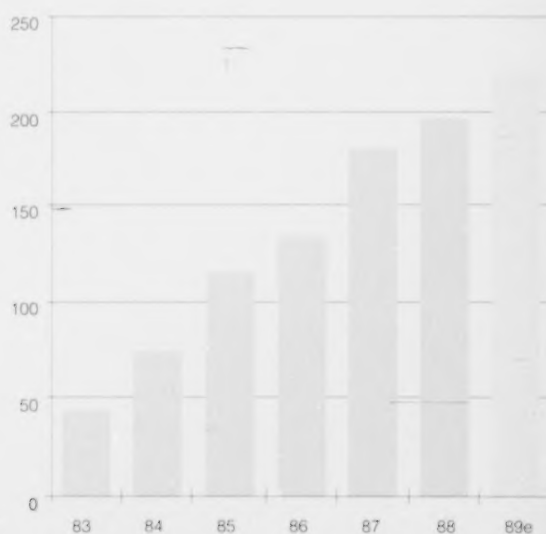
S & Ls Must Enhance Capital Base

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of August 1989, also known as the “S & L bailout bill,” requires S & Ls to maintain capital equal to 1.5% of assets by end-1989 and 3% “tan-

Nonperforming Loans at U.S. Banks Taper Off
(Billions of dollars)



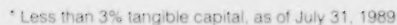
Bank Failures Hit New Record in 1989
(Number of bank failures per year)



FIRREA stated that thrifts should eventually meet bank standards and that 3% should be viewed as a minimum. Risk-based capital guidelines that are being phased in for banks will also apply to thrifts by 1992. The

There is a fairly broad consensus that the deposit insurance system, based on flat-rate pricing with no consideration to risk, contributed in large measure to the S & L crisis and the collapse of the Federal Savings and Loan Insurance Corporation (FSLIC) fund. The majority of regulators, legislators, academicians, and financial experts agree that reforming the system should be elevated to a national priority to avoid a repetition of the recent S & L crisis. There are, however, a wide range of proposals for reform—motivating Congress to mandate a study to be completed in early 1991. Among the issues to be considered are: (a) establishing risk-weighted premiums; (b) limiting each customer to one insured account; (c) reducing coverage and applying a graduated scale ranging from 100% coverage to zero coverage; (d) instituting coinsurance using private insurers; (d) limiting coverage of brokered accounts; and (e) requiring bank and thrift examiners to be in close contact with private auditors.

The crisis atmosphere surrounding the S & L bailout provides a once-in-a-lifetime opportunity to marshal national support for fundamental reform. With the bailout estimated to cost \$159 billion over 10 years and nearly \$300 billion over 30 years, with nearly 1,000 thrifts unprofitable and 500 of these insolvent, and with the Resolution Trust Corporation saddled with about \$400 billion in assets to dispose of (\$300 billion in real estate).



the case for reform is quite clear.

U.S. Saving Rate On the Rise

The personal saving rate in the United States, on a declining trend since the mid 1970s, has finally begun to rise after reaching a postwar low of 3.2% of disposable income in 1987. This low rate caused widespread concern about the "spendthrift habits of individuals who wanted instant gratification" instead of being willing to save and invest. Had this trend continued, it could have ultimately led to a decline in the American standard of living by limiting the funds available for investment in productive assets. Many believed that the United States was losing its economic standing in the world due in part to its low saving rate. In recent years, domestic investment has exceeded national saving, requiring foreign capital inflows to fill the "gap."

As the accompanying graph indicates, the saving rate has moved up to an estimated 5.6% in 1989, and we expect it to continue to increase over the forecast horizon, reaching over 6% by 1991. There are several explanations for the reversal in this saving trend. Demographic changes, specifically, the aging of Americans, mean that most of the "baby boomers"

have purchased homes and are now starting to save for their children's education and their own retirement. Measurement of the saving rate is another issue, as the U.S. Commerce Department treats saving as a residual of very large numbers (income after taxes and consumer spending), which means this number is easily distorted, prone to errors, and may understate actual saving.

Comparison between the U.S. saving rate and that of many of our major competitors abroad is initially somewhat alarming since the U.S. rate appears to be so much lower—especially against Japan. Again, due to measurement differences, accounting discrepancies, and socioeconomic factors, adjustments must be made in order to make valid comparisons. When these adjustments are made, the differences between saving rates narrow significantly. To promote further saving in the United States, it would be helpful to remove the disincentives to save and invest, such as the double taxation of dividends and the high capital-gains tax. Most other industrialized countries have tax codes that are less punitive to savers

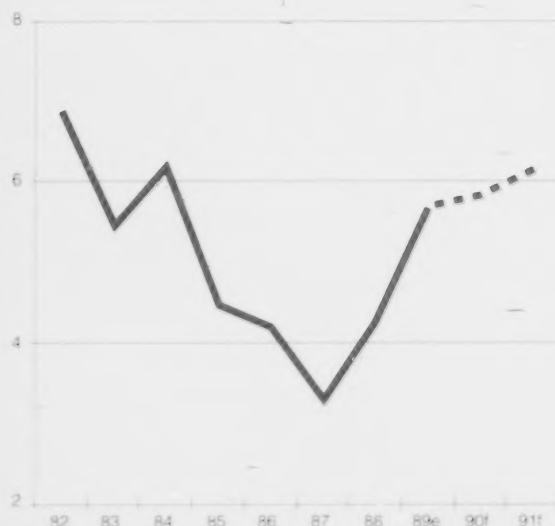
Leveraged Buyouts—Caution Advised
Leveraged buyouts (LBOs) have continued to grow, along with a sharp rise in

defaults of junk bonds that are in large part used to finance the LBOs. The junk-bond market (high-risk, high-yield securities) has mushroomed during a very long economic expansion. The question arises as to how this market will fare during a significant slowdown in the economy. Junk-bond defaults reached \$4.0 billion in 1988 and are estimated to reach over \$5.5 billion this year, as the accompanying graph indicates. This has caused the interest-rate spread for junk bonds to be quite high, since investors are perceiving greater risk. Those companies that are in a position to reduce outstanding junk bonds are doing so—often by selling off parts of the company and/or slashing costs to raise the necessary funds.

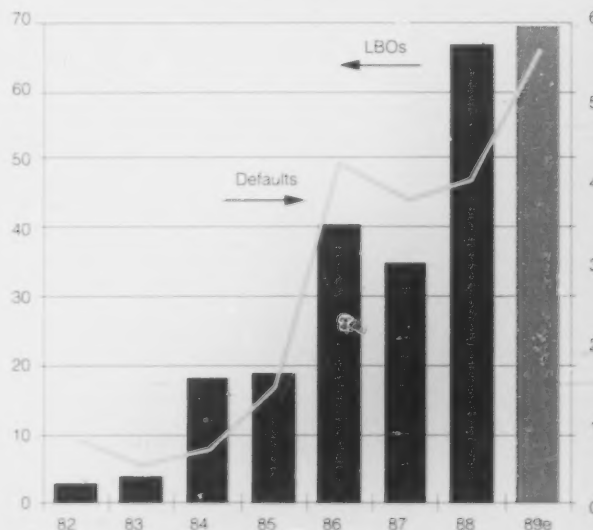
The volume of LBOs is estimated to reach \$70 billion by the end of 1989, compared with only \$3 billion as recently as 1981. The fact that the incidence of defaults in the junk-bond market has been escalating while the economy is still healthy indicates that the situation could worsen significantly during a recession. Some commercial banks that are holding significant portfolios of junk bonds could experience problems as a result. While our forecast is not for a severe economic downturn, segments of the LBO market could face difficulties.

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U.S. Saving Rate Increases
(Saving as a percent of disposable personal income)



LBO Transactions and Junk-Bond Defaults Escalate
(Billions of dollars)



First Interstate Territory



First Interstate Territory, a grouping of 21 states and the District of Columbia, is likely to realize growth slightly above the national average in the three years, 1989-91. This would be a reversal of the Territory's performance relative to the nation's in the recent past. Our forecast is for employment to rise an average of 1.4% in the Territory in 1990 and 1.9% in 1991. The comparable national growth rates are 1.0% and 1.8%.

Certain parts of the Territory continue to be beleaguered by real estate problems, with high vacancy rates. The resulting lower rents, however, will attract new business. The business climate in the Territory seems to be generally close to the

national average and slightly better in terms of education.

The Territory should benefit from less volatility in the overall economic environment in the next few years. Most states will experience some impact of the national slowing in the latter part of 1989 and early part of 1990. Each of the states, however, should manage to post some job growth in the period through 1991. The Pacific Southwest (Arizona, California, Hawaii, and Nevada) is likely to register the highest growth during the next two years.

States Show Growth

The Territory of First Interstate Bank's network encompasses 21 states and the District of Columbia. This area will produce an estimated \$1.86 trillion of goods and services in 1989, equal to approximately 36% of total U.S. GNP.

Beginning in 1988, each of the Territory's states turned in some increase in employment, and we expect this positive trend to continue through 1991. The region's performance will be affected by national trends, but in contrast to the past four years, we expect the Territory to outperform the nation by a small margin.

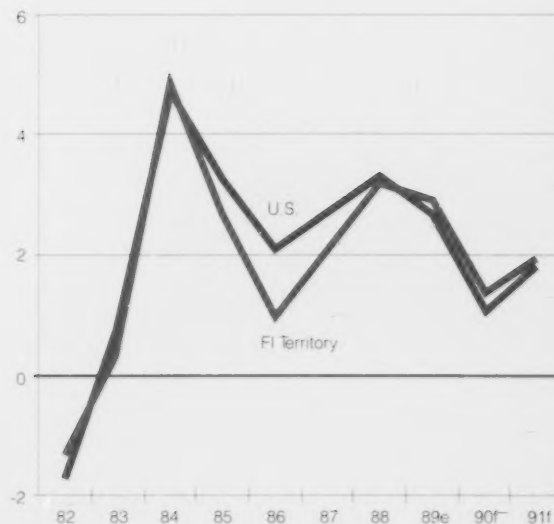
The average gain in the Territory's employment in 1989 is estimated at 2.8%, compared with a national increase of 2.7%.^{*} Territory growth is then likely to ease to an average of 1.4% in 1990 versus 1.0% for the country as a whole. We expect somewhat faster average growth in 1991, with a gain of 1.9% in the FI region, slightly higher than the U.S. increase of 1.8%.

**Most of this section is discussed in terms of annual averages, whereas the numbers in the "U.S. Economy" section were generally on a fourth-quarter-to-fourth-quarter basis.*

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FI Territory to Have Slight Growth Edge

(Annual percent change in nonfarm employment)



Major Forces in the Outlook

Performance of each of the states in FI Territory, with the exception of Alaska, is correlated with that of the nation. The impact of tight monetary policy will be to slow growth in the region in the latter part of 1989 and first part of 1990. This is reflected in the lower average growth rate for 1990. The industrial states of Wisconsin and Indiana, along with some counties in California, will be especially affected by any cutbacks in manufacturing.

A return to more accommodative monetary policy should allow economic activity in the Territory to begin improving by the middle of 1990. Continuation of better performance is forecast through 1991.

Efforts by the Federal Reserve to reduce and control inflation should prevent the extreme volatility that has afflicted some of the FI Territory states in the past. While surges in commodity prices stimulated growth in certain of the resource-dependent areas, the subsequent shifts to tighter money caused severe downswings. A more stable monetary policy should facilitate steadier and more consistent growth in all of the Territory states.

International trade is important to a number of FI states. Exports are particularly significant to such states

as Alaska and Washington in the Pacific Northwest and Texas and Louisiana in the South. For states such as Louisiana, the products exported may originate primarily from a number of surrounding states.

Our forecast is for the dollar generally to be below its high levels of late summer 1989 until at least the latter part of 1991. This should help tourism in such states as Nevada and Hawaii, bolster the farm exports of such states as Iowa, and help support commodity and manufactured exports from a number of states.

Export demand should also help to stabilize the farm sector, while government subsidies are reduced in coming years. Metal prices will not gain from stronger demand as inflation hedges, but they should benefit from steadier industrial demand after economic growth picks up in the second half of 1990.

Oil prices averaging \$16-18 a barrel (West Texas Intermediate) through the end of 1991 will spark no major increase in drilling activity, but a moderate pace of drilling should occur. The level of oil prices will also constrain the exploration and development of natural gas resources, although demands for "cleaner" energy sources should provide some support.

We expect U.S. housing starts to

average about 1.5 million units over the next two years, a level moderately positive for the lumber and plywood industry. A bigger concern for loggers is the outcome of environmental disputes over the cutting of public timber.

One major dampening force for the Territory is the cutback in defense. With the real value of military outlays likely to decline 2-3% a year through 1991, certain firms and communities will face substantial layoffs. The District of Columbia, New Mexico, and certain metropolitan areas of California are the most susceptible to defense cutbacks because of their greater dependence on military spending.

Competitive Business Climates

With various domestic firms restructuring and consolidating operations, while foreign companies move some of their production to this country, states are beginning to analyze more carefully their competitive positions. The relevant factors may differ widely from one industry to another or from one firm to the next.

Nevertheless, as summarized in the accompanying table, four factors seem to be generally important. (1) *Education* of the work force has gained increasing prominence. The grading in the table is based on high school and college education as well as adult

Exports Key To Certain FI Regions
(Exports as percent of total personal income, 1988e)



BUSINESS CLIMATE FACTORS

(Scale 1 to 5, 5 is most favorable)

	Education	Tax	Infra-structure	Tech-nology
AK	5	5	3	2
AZ	2	2	3	4
CA	3	3	5	5
CO	5	4	5	5
HI	4	1	4	3
ID	5	4	2	2
IN	2	3	1	3
IA	3	1	2	3
LA	1	4	1	1
MT	5	3	2	1
NV	4	5	2	3
NM	2	5	3	5
ND	4	5	2	2
OK	3	5	1	3
OR	3	2	5	3
SD	4	3	3	1
TX	1	5	5	4
UT	4	1	4	5
WA	5	2	5	5
WI	5	1	4	4
WY	5	1	4	1
FI Terri-tory	3.6	3.1	3.1	3.1

Sources: The Corporation for Enterprise Development and Grant Thornton

literacy, as tabulated by the Corporation for Enterprise Development (CED). First Interstate Territory ranks somewhat better than average with respect to education.

As pictured in the accompanying graph, college education and state per capita income are positively correlated.

One might argue about the direction of causality, and there may well be feedback between the two, but the importance of education to economic achievement is clear.

(2) *Tax policy* affects many location decisions. The table reflects a ranking by the Grant Thornton accounting and consulting firm of states' relative tax burdens based on a number of different kinds of taxes.

(3) *Infrastructure* and recreational facilities are reflected in most surveys assessing the relative competitiveness of different states. The CED measure used in the table is based on a broad array of indicators, including transportation systems, energy and housing costs, medical care, and recreational activities.

(4) *Technological resources* are becoming more important to a number of industries. The CED index used in the table ranking is based on indicators including the relative number of scientists and engineers in the workforce and university research and development spending per capita.

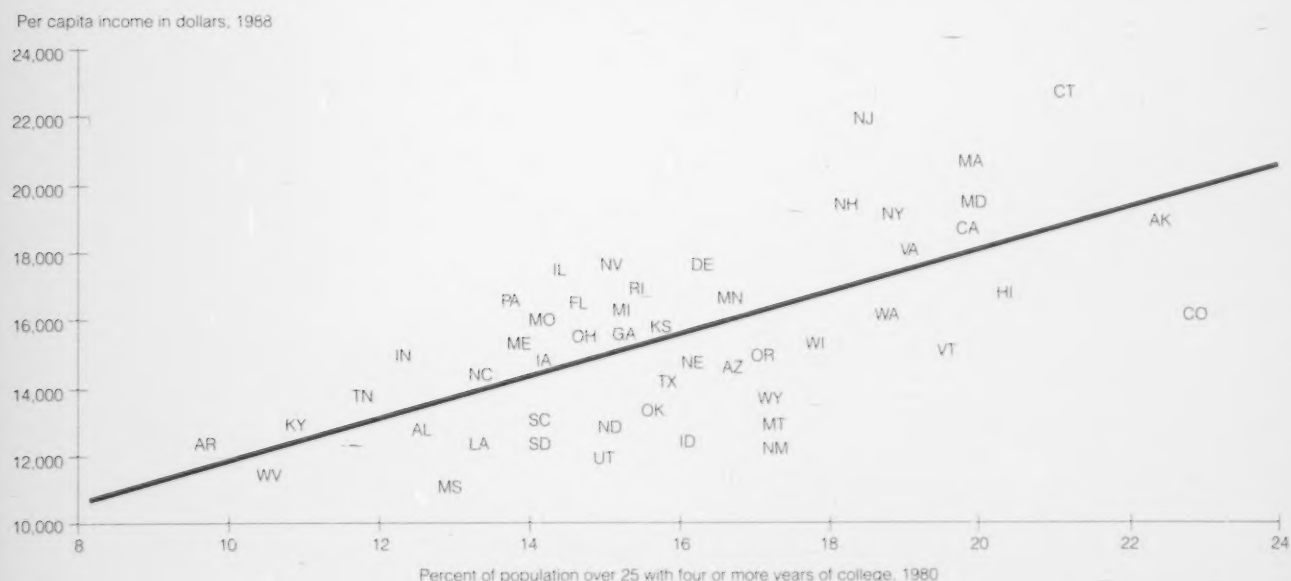
Measures comparing competitive climates must be used carefully and involve various theoretical and data limitations. However, the measures analyzed here indicate that FI Territory generally ranks about average in terms of the four summary indicators.

Commercial Real Estate Plagued By Excess Capacity

In many regions of First Interstate Territory, office vacancy rates continue to be higher than the national average. As of June 1989, downtown office vacancy rates were highest in Oklahoma City (36%), San Antonio (29%), Austin (27%), Denver (26%), and Phoenix (23%). The depressed energy sector in the second half of the 1980s is clearly the principal factor that has led to overcapacity in four of these metropolitan areas. In the case of Phoenix, demographic changes—a slowdown in in-migration—has reduced the absorption rate of new residential units and of commercial buildings. Within the FI Territory, Honolulu (5%) and Sacramento (6%) have the lowest vacancy rates, reflecting the strong growth of those local economies.

Of the five most overbuilt areas in FI Territory, Oklahoma City is the most affected commercial office market. Despite the lengthy expansion of the U.S. economy, its downtown vacancy rate has climbed from only 9% in 1983 to 36% in 1989. The situation in San Antonio has continued to deteriorate, with the vacancy rate moving up from 22% in 1987 to 29% in 1989. In Phoenix, this rate has also moved up in the past two years to 23% in 1989 from 19% in 1987. By

Income and Education Highly Correlated



contrast, both Austin and Denver have experienced improvement in the past year, as their office vacancy rates have declined to 27% and 26%.

For suburban office space, the national average as of mid 1989 was 21%, considerably higher than for downtown office space. Again, the highest vacancy rates in this sector are in the Texas-Oklahoma-Colorado energy belt. Notably, Salt Lake City, Phoenix, and Tucson have also experienced some overbuilding. The 1981 tax law (which increased the incentives for investing in income property), combined with depressed energy and agricultural economies, contributed to excess inventories of commercial property. Given our forecast of relatively slow economic growth in the United States—and several regional economies within FI Territory—in 1990-91, the commercial building sector is not likely to return to much healthier conditions during our forecast horizon.

In the residential sector, the highest vacancy rates (latest data are for 1988) were in Dallas, Houston, Denver, Phoenix, and San Bernardino-Riverside. Residential vacancy rates two to three times those of other FI Territory areas were recorded in these five metropolitan areas. The outlook for absorption in California and

Arizona, where fairly strong economic growth is forecast for 1990-91, is relatively good. In Texas and Colorado, however, improvement is likely to be significantly slower.

Differences in Performance

For the purpose of analysis, the Territory states are divided into five regions: Pacific Southwest (Arizona, California, Hawaii, and Nevada); Pacific Northwest (Alaska, Idaho, Oregon, and Washington); Rocky Mountain (Colorado, Montana, New Mexico, Utah, and Wyoming); Midwest (Indiana, Iowa, North Dakota, South Dakota, and Wisconsin); and Southern Tier (Louisiana, Oklahoma, and Texas). Employment and income projections for these states and for the District of Columbia are shown in the table at the end of this section.

Pacific Southwest

Nonfarm employment is forecast to be stronger in the Pacific Southwest than in the other four regions of the Territory during 1990 and 1991, with increases of 1.9% and 2.6%, respectively. While these expansion rates will represent a deceleration from the 1988-89 growth rates, they are substantially higher than those projected for the nation as a whole. California's nonfarm jobs are forecast to grow by only 1.8% in 1990, one half

the estimated increase for 1989.

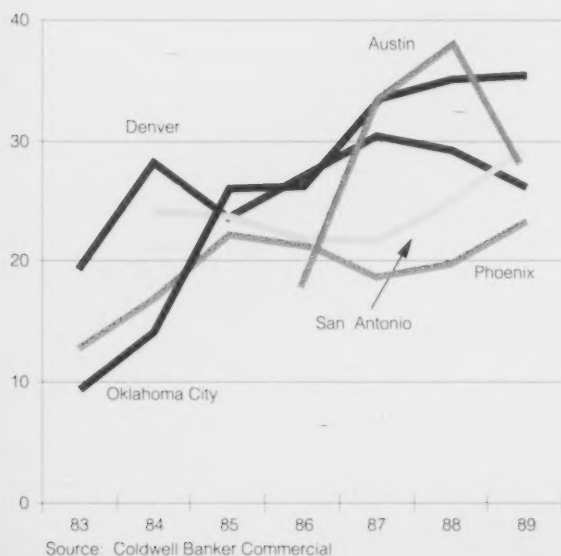
Nevada's growth rate in 1990 (2.8%) will be less than half its 1989 increase, while Hawaii will also show a more modest gain of 2.0% in 1990. Arizona's economy, having peaked in 1984 and turning in a lackluster performance in 1989, will regain some strength in 1990, with a gain of 2.8% in nonfarm jobs—the strongest in the Territory. Supporting strong growth in this region are the attractiveness of its job opportunities, its natural environment's appeal to tourists, and expanding trade with the Pacific Rim and Mexico as the dollar falls against major currencies in 1990. Moderating the growth of the region will be the cutbacks in defense spending (especially California) and some softness in commercial as well as residential construction. Even booming California home prices are likely to decelerate in 1990-91. Personal income growth is expected to be very strong in this region in 1990—9.0% in Nevada, 7.8% in Hawaii, 7.2% in Arizona, and 7.0% in California, all above the 6.1% average for the nation.

Pacific Northwest

The Pacific Northwest, with growth in nonfarm employment of 1.6% forecast for 1990, will nearly match the Pacific Southwest's expected performance. The strongest state economy in this group is Washington, which will record an

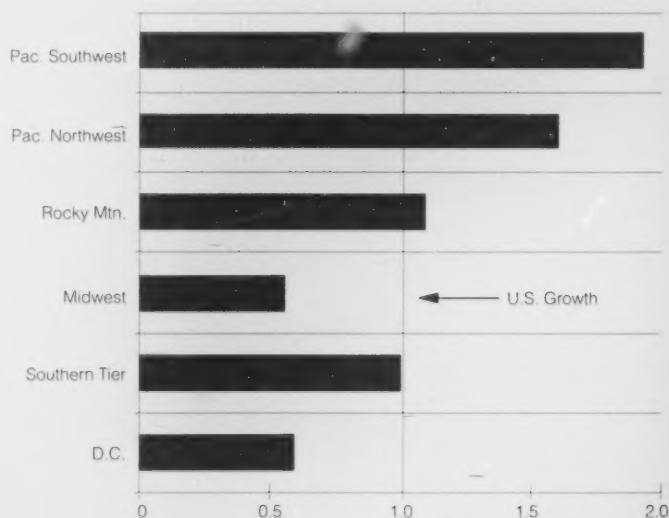
Most Overbuilt Areas in FI Territory

(Office vacancy rates, June 30)



The West Leads the U.S. in 1990

(Percent change in nonfarm employment)



increase in jobs of 2.0% in 1990—double the national average. In large part, this relatively strong growth will result from the huge order backlogs at Boeing for commercial aircraft.

Lumber production in Washington and Oregon, as well as the oil industry in Alaska following the Valdez spill, will feel some pressure from the growing conservationist movement. The falling dollar in 1990 will help manufacturing exports from the region, but this will be reversed in 1991. Personal income in three of the four states (Alaska, Idaho, and Washington) is expected to increase in 1990 at the same rate as the nation—6.1%—with Oregon just a bit higher at 6.4%.

Rocky Mountain

The five-state Rocky Mountain region will match the nation in nonfarm employment growth in 1990 (1.1%) and in 1991 (1.8%). Growth in this region in 1988-89 was partly dampened by dislocation of its agricultural sector caused by the drought, as well as relatively low oil prices. The agricultural sector in New Mexico, Utah, and Colorado should be boosted by higher farm prices and a rebound from drought conditions. Cutbacks in defense spending will have negative effects on certain states, in particular New Mexico, which is sensitive to changes in the flow of dollars to

support military research and development. Our forecast of oil prices, only in the upper teens in 1990-91, does not bode well for a revitalization of the energy sector in Colorado, New Mexico, and the rest of the region. A weaker dollar in 1990 will help exports of manufactured goods, including high-tech products. Personal income growth in four of the five states in this region—the exception being New Mexico—will be below the national average in 1990.

Midwest

Nonfarm employment growth in the five Midwest states will be weaker than for the nation as a whole in both 1990 and 1991, with rates of 0.6% and 1.6%, respectively. The slowdown in the national economy in late 1989 and early 1990 will have negative impacts on the demand for automobiles and steel (Indiana), as well as the demand for consumer appliances (Indiana, Iowa, and Wisconsin). The region should, however, benefit from fairly high government farm-subsidy payments and higher farm prices. Defense cutbacks could hurt employment and income in North Dakota, where military bases are located. Exports of farm machinery and equipment, as well as high-tech products, should benefit from the lower dollar in 1990. All of the states in this region

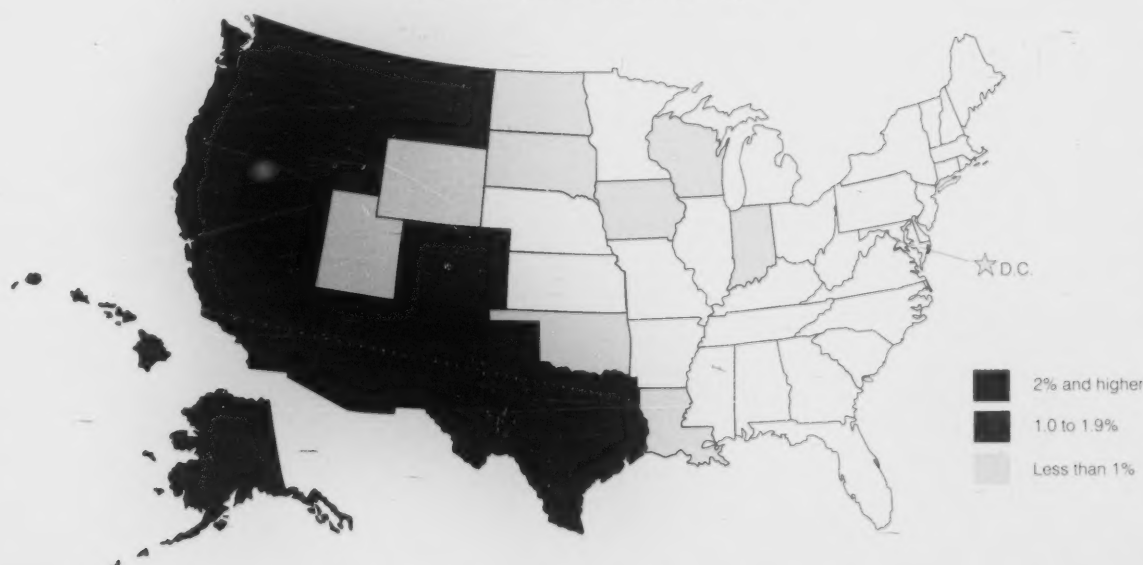
will be turning in somewhat lackluster performances in personal income growth in 1990, ranging from 4.7% for South Dakota and Iowa to 5.6% for Wisconsin and Indiana.

Southern Tier

This region, dominated by Texas, is recovering from the severe oil-induced slump that started in 1986. Boosted by a vigorous petrochemical industry, diversification into high technology and health care, and stronger efforts to expand exports, the region will at least match the nation in employment gain in 1990, with a growth of 1.0%. Oil prices of \$16-18 a barrel during the forecast horizon will not provide the catalyst to revive the energy industry. One of the impediments to a stronger pace of economic activity will be excess capacity in both office and residential buildings, compounding the weakened condition of the region's banks and savings institutions. Higher cattle and cotton prices in 1990 will help boost the Texas economy, while food processing and transportation equipment should be sources of strength in both Louisiana and Oklahoma. Louisiana's (7.0%) and Texas' (6.2%) personal income will increase faster than the nation's in 1990, but Oklahoma's (4.7%) is likely to lag substantially behind.

The Strongest and Weakest States in 1990

(Forecast FI state employment growth)



NONFARM PAYROLL EMPLOYMENT

	1988		1989e		1990f		1991f	
	Thousands	% Change	Thousands	% Change	Thousands	% Change	Thousands	% Change
Alaska	212	1.0	218	2.7	220	1.0	222	1.1
Arizona	1,411	1.8	1,437	1.9	1,477	2.8	1,525	3.3
California	12,136	3.9	12,573	3.6	12,800	1.8	13,120	2.5
Colorado	1,426	0.9	1,447	1.5	1,462	1.0	1,491	2.0
District of Columbia	673	2.7	687	2.1	691	0.6	701	1.4
Hawaii	477	3.7	492	3.1	502	2.0	513	2.2
Idaho	349	4.6	362	3.7	368	1.8	377	2.3
Indiana	2,398	4.1	2,463	2.7	2,475	0.5	2,517	1.7
Iowa	1,156	4.2	1,193	3.2	1,203	0.8	1,219	1.4
Louisiana	1,502	1.2	1,519	1.1	1,532	0.9	1,551	1.2
Montana	279	1.8	283	1.5	286	1.0	289	1.0
Nevada	538	7.5	572	6.3	588	2.8	604	2.8
New Mexico	540	2.1	552	2.3	563	2.0	574	1.8
North Dakota	256	1.2	259	1.1	260	0.6	263	0.9
Oklahoma	1,133	2.2	1,144	1.0	1,151	0.6	1,160	0.8
Oregon	1,152	4.1	1,192	3.5	1,204	1.0	1,222	1.5
South Dakota	264	2.8	267	1.0	268	0.6	271	1.1
Texas	6,647	2.0	6,787	2.1	6,861	1.1	6,957	1.4
Utah	660	3.2	684	3.6	689	0.7	701	1.8
Washington	1,936	4.7	2,033	5.0	2,073	2.0	2,111	1.8
Wisconsin	2,149	2.8	2,196	2.2	2,207	0.5	2,243	1.6
Wyoming	183	0.1	184	0.8	186	0.8	189	1.5
FI Territory	37,476	3.1	38,544	2.8	39,068	1.4	39,820	1.9
U.S.	105,584	3.3	108,387	2.7	109,500	1.0	111,430	1.8

PERSONAL INCOME

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	1988		1989e		1990f		1991f	
	\$ Billions	% Change	\$ Billions	% Change	\$ Billions	% Change	\$ Billions	% Change
Alaska	10.0	3.4	10.8	8.4	11.5	6.1	12.2	6.1
Arizona	52.2	7.3	55.7	6.7	59.8	7.2	64.3	7.7
California	531.0	8.1	580.9	9.4	621.5	7.0	670.6	7.9
Colorado	54.4	5.3	57.6	6.0	60.8	5.5	65.0	7.0
District of Columbia	13.2	8.7	14.6	10.7	15.7	7.5	16.9	7.7
Hawaii	18.4	9.2	20.2	9.7	21.8	7.8	23.5	8.2
Idaho	12.7	7.7	13.7	8.1	14.6	6.1	15.6	7.1
Indiana	82.9	7.2	88.8	7.1	93.8	5.6	100.4	7.0
Iowa	41.6	4.9	44.5	7.1	46.6	4.7	49.4	6.0
Louisiana	54.2	5.9	59.1	9.0	63.2	7.0	67.9	7.5
Montana	10.4	4.0	11.1	7.4	11.8	5.8	12.5	5.9
Nevada	18.5	12.2	20.8	12.9	22.7	9.0	24.8	9.0
New Mexico	18.8	5.8	20.4	8.2	21.7	6.5	23.2	6.8
North Dakota	8.6	-0.6	9.0	5.0	9.4	4.7	9.9	5.2
Oklahoma	43.2	5.1	45.7	5.9	47.9	4.7	50.3	5.1
Oregon	41.2	8.7	45.1	9.4	47.9	6.4	51.4	7.2
South Dakota	9.1	3.3	9.6	5.9	10.1	5.2	10.7	5.9
Texas	245.6	5.8	265.3	8.0	281.7	6.2	300.6	6.7
Utah	20.6	6.4	22.4	8.5	23.5	5.2	25.0	6.5
Washington	76.6	7.8	83.8	9.4	88.9	6.1	94.3	6.1
Wisconsin	75.4	6.8	81.7	8.4	86.3	5.6	92.2	6.9
Wyoming	6.5	3.8	6.9	6.3	7.3	6.0	7.9	7.0
FI Territory	1,444.9	7.0	1,567.7	8.5	1,668.4	6.4	1,788.7	7.2
U.S.	4,053.0	7.6	4,401.5	8.6	4,670.0	6.1	5,001.6	7.1

Note: Calculations based on unrounded data.

FIRST INTERSTATE BANCORP

BANKING AFFILIATES

Alaska

First Interstate Bank of Alaska

Arizona

First Interstate Bank of Arizona, N.A.

California

First Interstate Bank of California

First Interstate Bank, Ltd.

Colorado

First Interstate Banks of Denver, N.A.,
Englewood, N.A., and Fort Collins, N.A.

Idaho

First Interstate Bank of Idaho, N.A.

Montana

First Interstate Banks of Glacier County,
Great Falls, and Kalispell, N.A.

Nevada

First Interstate Bank of Nevada, N.A.

New Mexico

First Interstate Banks of Albuquerque,
Lea County, Roswell, and Santa Fe, N.A.

Oklahoma

First Interstate Bank of Oklahoma, N.A.

Oregon

First Interstate Bank of Oregon, N.A.

Texas

First Interstate Bank of Texas, N.A.

Utah

First Interstate Bank of Utah, N.A.

Washington

First Interstate Bank of Washington, N.A.

Wyoming

First Interstate Banks of Casper, N.A.,
Laramie, N.A., Riverton, N.A.

BANK LICENSEES

Colorado

First Interstate Banks of Arvada,
Centennial, Golden, and
Westminster

First Interstate Bank of South Fort
Collins

District of Columbia

First Interstate Bank of Washington,
D.C.

Hawaii

First Interstate Bank of Hawaii

Indiana

First Interstate Bank of Northern
Indiana, N.A.

Iowa

First Interstate Bank of Iowa

Louisiana

First Interstate Bank of Southern
Louisiana

Montana

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Billings Heights, Colstrip, Hardin,
Miles City, Missoula, and West
Billings

New Mexico

First Interstate Bank of Farmington

North Dakota

First Interstate Bank of Fargo, N.A.

South Dakota

First Interstate Bank of South Dakota, N.A.

Wisconsin

First Interstate Bank of Wisconsin

Wyoming

First Interstate Banks of Buffalo,
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and Sugarland

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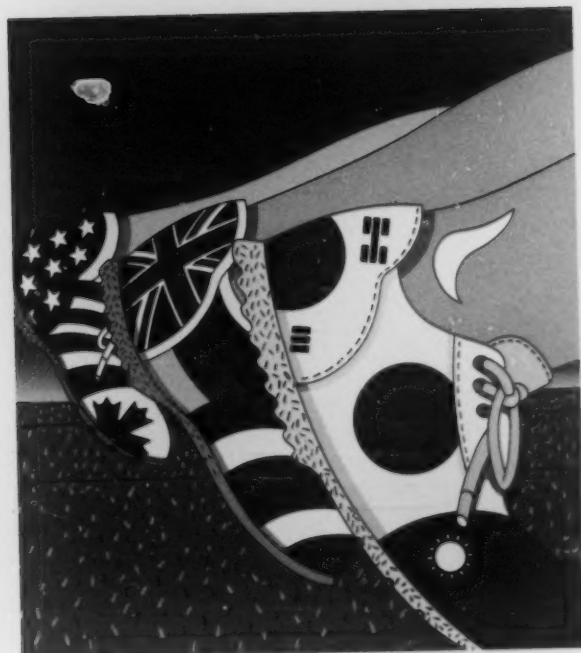
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FORECAST

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UPDATE

February 1990

First Interstate Territory Edition

 **First
Interstate**
Bancorp

FIRST INTERSTATE BANCORP

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Iowa

First Interstate Bank of Iowa

Louisiana

First Interstate Bank of Southern
Louisiana

Montana

First Interstate Banks of Billings, N.A.,
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Miles City, Missoula, N.A., and West
Billings

New Mexico

First Interstate Bank of Farmington

North Dakota

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and Sugarland

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Overview

The slow national economic growth of late 1989 and early 1990 will set the stage for a more sustainable pace of expansion well into the new decade. Output and employment growth will increase later this year and in 1991, but will stay well below the robust expansion of 1987-88. Inflation reached a cyclical peak in the first half of 1989 and can be expected to decline for at least the next two years.

This outlook for modest growth and falling inflation for the near future will be accompanied by substantially reduced volatility of interest and exchange rates compared with the previous two decades. Oil prices are expected to average somewhat below \$20 a barrel through 1991, and food prices will retreat from the recent cold-weather induced highs. Consumer spending will grow at a subdued rate, and major sectors such as residential construction and automobile production will operate at much lower levels than in the mid 1980s.

Growth of capital spending by businesses in 1990 will be well below the rates of the past several years—a reflection of the contraction of corporate cash flows. However, capital spending in 1991 is forecast to be fairly robust. Exporting and import-competing industries will continue to outperform other sectors of the economy.

Defense spending by government will fall by about 4% a year in real terms for much of the 1990s, so the regions and industries of the economy that were stimulated by the military buildup of the 1980s will be adversely affected in this decade. Spending by government and private industry for environmental purposes will trend higher for many years to come.

The torrid rate of real estate price increases during the late 1980s is now over for most of the country. For 1990-91, appreciation of house prices is not likely to exceed the rate of inflation except in the Pacific Northwest. The overhang of assets to be sold by the government, acquired from failed thrifts and banks, will continue to depress real estate markets in some Southwestern and Northeastern states.

Although the unemployment rate is forecast to rise somewhat this year, the Federal Reserve is not expected to shift to a sharply more stimulative monetary policy. Sustained monetary restraint means that such indicators as personal income and retail sales will grow more slowly on average than in the recent past. The resulting shortfall of tax receipts at both the state and the federal level will constrain spending by governments.

Highly restrictive monetary policies in response to unacceptable inflation have been adopted by most major countries. Consequently, real economic growth will be slower in industrial countries in 1990, with the sharpest

slowing occurring in Canada and the United Kingdom. Modestly faster growth in 1991 is expected as policy-makers ease up a bit.

Inflation rates of industrial countries are converging in the 3-5% range. That range is higher than central bankers claim to be comfortable with, but it appears to be acceptable to politicians. Those countries with recent inflation above that range, such as Canada and the United Kingdom, will have to endure monetary restraint longer in order to rejoin the "price stability club" of major countries.

First Interstate Territory

Growth of personal income and employment in the 19 First Interstate states finally caught up with the rest of the nation in 1989 after lagging behind during the prior three years. For 1990-91, we expect Territory states to average somewhat faster growth than the average of the rest of the country.

Growth will continue to be fastest in the Pacific Northwest and in Nevada. California is slowing sharply from the boom conditions of 1987-89, but still outperforming the national economy. Texas is recovering from the earlier slump. The Rocky Mountain states are finally performing better, and the Northern Plains states are about keeping pace with the national average growth rates.

February 20, 1990

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The International Economy

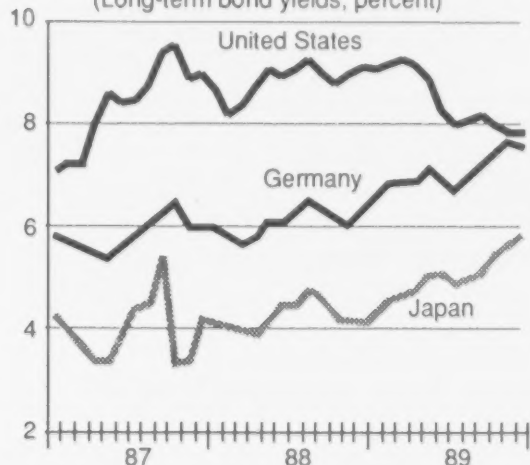
Continued Strong Growth, Higher Interest Rates in Industrial Countries

Growth among the six major industrial countries outside the United States is currently showing varying patterns. The two largest economies, Japan and Germany, continue to grow at relatively rapid rates. In the case of Japan, domestic demand growth is the leading factor, while the country's current-account surplus fell substantially during 1989, reaching \$57.0 billion compared with \$79.6 billion in 1988.

In Germany's case, continued, strong export growth has been a leading factor, with exports to other European countries performing well. Germany's current-account surplus has risen and is likely to exceed that of Japan by a substantial margin during 1990. A further factor in Germany's improved growth prospects has been immigration. During 1989, nearly 700,000 immigrants arrived in West Germany, about half accounted for by ethnic Germans from East Europe and the remainder from East Germany. The influx of immigrants may account for half a percentage point of 1990 GNP growth, keeping the increase at about 3.5% following a 4.0% rise in 1989.

The continued, relatively high rate of growth in Germany is partly attributable to the economic restructuring occurring in Europe in anticipation of the unification of markets that is occurring. Thus, growth throughout continental Europe is continuing at a strong pace.

Japanese, German Long-Term Rates Move Up
(Long-term bond yields, percent)



During the first half of 1990, all remaining controls on capital flows among the major members of the European Community will be eliminated. The free movement of capital among the EC members will limit the discretion of monetary policymakers in the smaller

countries, effectively bringing about a convergence of inflation and interest rates over time.

Among the larger European countries, the effects of market unification on fiscal and monetary policy appear to be the greatest in Italy, where a very large public-sector budget deficit (approximately 11% of GDP in 1989) is responsible for upward pressure on real interest rates. The requirement for funding this deficit is the basic reason why Italy has been the last of the large economies to phase out controls on capital movements. Unless the government can effectively convince financial markets that it can make major progress in cutting the budget, Italian interest rates will have to remain significantly above interest rates elsewhere in Europe.

Monetary policy has been tightened in both Japan and Germany, resulting in higher interest rates. Rising, but still moderate, inflationary pressure has been behind this rise, although currency weakness due to political factors has also contributed to the Japanese rate increases. It is probable that short-term rates in Japan will rise further in the coming few months. Although German rates are likely to be near their peak, the situation of monetary policy is made unclear by the prospect of monetary union with East Germany. It is likely that interest rates will not drop very much during the year as (1) German government borrowing rises to accommodate increases in social expenditures and (2) the Bundesbank attempts to contain potential inflationary consequences of monetary union. The strength of the deutschemark resulting from high rates may result in an EMS realignment during the year.

The weakest economies among the major industrial countries are found in the United Kingdom and Canada. In the former, consumer prices in the latest month were 7.7% above their year-earlier level, and tight monetary policy to reduce this level of inflation will lower economic growth to only about 1%. In Canada, monetary authorities recently signalled their intention to gradually reduce the differential between Canadian and U.S. interest rates, but this gradual easing is not expected to prevent much slower growth in the economy this year.

Eastern European Developments

Aside from the possibly imminent and significant effects of German economic union on the economy of West Germany, developments in other Eastern European countries and in the USSR are still uncertain. Clearly, the direction of economic reform toward market pricing, larger private sectors, increased foreign investment, and more open trade regimes indicates that these countries will become more integrated into global markets over the medium term. In the short term, however, the effects are less clear. Several of the

countries will hold elections in the next few months, after which the pace of economic reform is likely to accelerate. Western companies are likely to increase the level of investment in these countries, although the prospects for direct trade between the United States and Eastern Europe are probably limited in the immediate future.

Eastern European Indicators (1988)

	Population (Millions)	GNP (\$ billions)	GNP/Capita (\$)
Bulgaria	9.0	67.6	7,510
Czechoslovakia	15.6	158.2	10,140
E. Germany	16.6	207.2	12,480
Hungary	10.6	91.8	8,660
Poland	38.0	276.3	7,270
Romania	23.0	126.3	5,490
Total	112.8	927.4	8,220
USSR	286.4	2535.3	8,850

The USSR is moving more slowly than most of the Eastern European countries, and the political situation in the Soviet Union is much more complex. The ouster of the Soviet Communist Party from power—now a distinct possibility—would probably mean more rapid economic reform in that country. It is clear, in view of shortages of many goods and declining national output, that more radical moves toward a market economy are required. The major threat to an acceleration of the reform process would be a party and/or military reaction that attempted to maintain the communist monopoly on power and prevent secessionist movements from succeeding. Should this occur, not only would prospects for the USSR itself look less positive, but the pace of reform in Eastern Europe would slow and, most likely, currency markets would take a much dimmer view of the deutchemark.

World Trade Growth Slows

The relentless integration of the world economy is reflected in world trade growth exceeding the real growth rate of the world economy. Since the worldwide recession in 1982, the volume of world trade measured by imports has risen at a compound rate of 6.2% annually, while collective real economic output in the industrial countries increased 3.6% per year.

World Trade (Imports, % change)

	1986	1987	1988	1989e	1990f	1991f
Volume	5.5	6.6	10.1	7.3	4.0	5.2
Nominal	9.4	17.1	15.8	11.9	6.6	10.3

For 1989, we estimate that the volume of world imports increased at a slower rate than during 1988 and

that its growth will slow further in 1990 before rising in 1991. The lower rate of expansion in 1989 and 1990 reflects the slower expansion of the world economy—seen in lower growth in the industrial economies. Collective real economic growth of industrial countries declined from 4.4% in 1988 to 3.1% in 1989, and our forecast is for it to fall further to 2.3% in 1990 before it increases modestly in 1991.

We expect that the growth rate for nominal world trade will show a similar pattern. This pattern reflects changes in prices as well as real growth rates of world trade. Import prices increased 4.0-4.5% in 1989, down from 5.1% in 1988. Although oil prices rose at a substantial rate, prices for other commodities probably declined somewhat for the year on average. Price rises for goods with a greater degree of processing were higher, however, as inflation rates generally rose worldwide in 1989 from 1988 levels.

During 1990, we expect price increases to moderate. Lower real economic growth should result in an actual decline in commodity prices generally. In addition, inflation rates for non-commodity goods will probably decrease because of anti-inflation policies pursued during 1988-89 by many industrial countries. In 1991, we look for prices for imports to rise at a substantially faster rate. Even though industrial-country inflation will probably slow somewhat from 1990 rates, energy and non-energy commodity prices should rise from 1990 levels.

Does the "Brady Plan" Have a Future?

Mexico at last signed its "Brady Plan" debt restructuring in early February, which included roughly 10% of the commercial-bank creditors giving the country new money, 40% opting for bonds at a reduced interest rate, and 50% for bonds at market rates but with the principal amount reduced 35%. Combined with moderate export growth, this agreement has contributed to an improved external financial position in Mexico.

It appears unlikely that most other heavily indebted countries will be able to benefit from similar agreements soon. Venezuela, which has adopted a fairly thoroughgoing economic reform program, will soon come to an agreement, but it may include less debt reduction than the Mexican accord. Similarly, an agreement with the Philippines may also be forthcoming. Looking at the major debtors in Latin America, however, considerable uncertainty remains. Both Brazil and Argentina continue to suffer from hyperinflation, and both countries have very large interest arrears with bank creditors. Thus, not only are the underlying economic conditions present in Mexico lacking, but the magnitude of the arrearages would make any negotiations more difficult. A new Brazilian government, coming to

power in March, is likely to attempt to implement major economic reforms, but their success remains problematic.

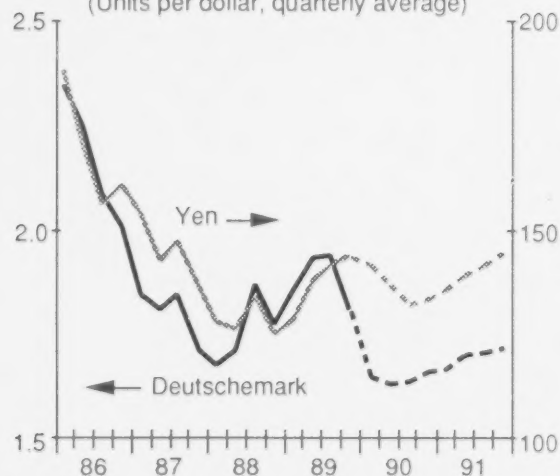
Thus, although the Mexican agreement was important in its own right, major debt reduction, as proposed by Secretary of the Treasury Brady, does not appear to be in prospect. Despite this, a few Latin America countries have taken steps necessary to make their economies competitive, and their prospects have improved. In those countries still suffering from large government sectors and hyperinflation, the direction of necessary reforms is no longer the question; only the political will to carry through with changes is now needed.

Dollar To Weaken Near Term Before Appreciating

The U.S. dollar proved surprising during the fourth quarter of 1989 and in early 1990 as it fell markedly against the deutschmark (and most other European currencies) and remained relatively constant with respect to the yen. On a monthly-average basis, the dollar declined 10.9% against the mark from September to December 1989, while it rose 1.0% against the yen. Its weakness against the mark resulted from the rapid progression of events in Eastern Europe and pressure in West Germany for higher interest rates because of heightened inflation concerns. These developments tended to reduce the real interest rate differential between Germany and the United States. The yen, on the other hand, was effectively hammered by several developments, including uncertainty about the ruling party's chances in elections for the lower house of the Diet to be held in mid February and because of developments in the USSR that potentially could affect oil prices.

Dollar Appreciates After Mid-1990

(Units per dollar, quarterly average)



Our forecast is for the dollar generally to depreciate against industrial-country currencies through mid

1990—10% against the mark through the second quarter and 8% against the yen through the third quarter from average fourth quarter rates. (At the end of January, the dollar had already depreciated 7.2% against the mark.)

Our outlook is for short-term U.S. interest rates to trend downward faster than the inflation rate declines through the first half of 1990, resulting in lower real interest rates. German rates have probably peaked or are close to their peak. In Japan, however, we expect that short-term rates will rise further as the Bank of Japan further curtails credit expansion to combat inflation pressures. Consequently, the differential between real interest rates in the United States and Japan will narrow considerably more from current levels than that between the United States and Germany.

Simultaneously, we expect that the ruling party in Japan will continue to form the Japanese government after the February election, whether alone or in a coalition, which will eliminate part of the uncertainty existing in the foreign-exchange markets.

After midyear, we look for the dollar to regain part of its earlier losses. U.S. interest rates will trend upwards, while inflation rates change little. We expect the dollar to appreciate 2% against the mark from the second quarter through the fourth quarter of 1990 and 2% against the yen. During 1991, we are forecasting a 4% gain against the mark and an 8% rise with respect to the yen.

Current-Account Deficit Declines Through 1990

The U.S. merchandise-trade deficit decreased in 1989 as export growth exceeded that for imports. The decline in the trade deficit is less than we estimated in October as the U.S. economy proved to be stronger than we anticipated, which buoyed import growth. For the year, exports grew at an estimated 13.5% rate, while imports increased 6.9%.

Data for the first three quarters of 1989 indicate that we are unlikely to see a drop in the service surplus in 1989 similar to that in 1988 when it was almost halved. In fact, we believe that it will increase from its 1988 level. It decreased markedly during first half 1989, recording a \$0.2 billion deficit. During the third quarter, however, the services account shifted to an \$8.7 billion surplus, as the depreciation of the dollar between the second and third quarters raised the dollar value of earnings on U.S. investment abroad. The depreciation of the dollar against the mark and other European currencies during the fourth quarter implies another services surplus is likely to have occurred during the fourth quarter.

U.S. Current Account (Billions of Dollars)

	1987	1988	1989e	1990f	1991f
Trade balance	-159.5	-127.2	-114.7	-110.7	-116.2
Exports	250.3	319.3	362.4	395.0	427.4
Imports	-409.8	-446.5	-477.1	-505.7	-543.6
Services balance	30.0	15.3	17.1	19.6	10.8
Service exports	195.9	210.6	235.3	254.8	265.0
Service imports	-165.9	-195.2	-218.2	-235.2	-254.2
Transfers balance	-14.2	-14.7	-15.5	-17.0	-18.2
Official	-10.2	-10.4	-10.9	-12.0	-12.8
Private	-4.1	-4.3	-4.6	-5.0	-5.4
Current-account balance	-143.7	-126.5	-108.5	-103.1	-123.6

During 1990, we expect that export growth will continue to exceed that for imports. Export growth, however, will likely decrease to about 9% from the 13.5% rate for 1989, given slower economic expansion abroad during the year in comparison to 1989's growth. The recent weakness of the dollar will probably have comparatively little effect on U.S. exports during 1990. We look for import growth to decrease to approximately 6% in 1990, reflecting slower domestic real economic growth, especially during the first half of the year. We anticipate that the service surplus will increase modestly from its 1989 level. The larger surpluses will occur during the first half of the year when we expect the dollar generally to depreciate against other currencies. During second half 1990, the appreciation of the dollar should result in a reduced surplus.

In 1991, we anticipate that the trade deficit will widen as faster domestic growth spurs import demand. Faster growth abroad in comparison to that in 1990 will lead to continued U.S. export growth, but without a sustained, sizable depreciation of the dollar in relation to major U.S. trading partners, faster export growth than that forecast will be difficult. The appreciation of the dollar from mid 1990 on through end 1991 is likely to result in a services surplus that is cut in half from the year-earlier level.

The current-account deficit for both 1989 and 1990 should continue to decrease as a share of GNP—2.1% and 1.9%, respectively, but the 1991 deficit would rise to 2.1%. Nevertheless, the deficits imply that the United States must attract a net annual capital inflow of \$100 billion or more. A higher level of interest rates may be required to induce that capital inflow if developments abroad imply diminished competitiveness for U.S. assets. In any event, the trend is that the services surplus should tend to erode \$7-9 billion annually, other things remaining unchanged.

The U.S. Economy

Changes Since October

Since publication of our *Forecast* last October, a number of changes have taken place—some of which will produce only temporary effects, while others will have long-term impacts.

(1) Unusually cold weather in various parts of the United States at the end of 1989 pushed food and energy prices up steeply. Although unsettling to consumers, the resulting spike in inflation in the first part of 1990 will be temporary.

(2) Long-term interest rates have climbed sharply in the first part of 1990, in part because of the rise in interest rates abroad. U.S. interest rates are now very high relative to expected inflation and economic growth and are, therefore, likely to move lower.

(3) The pace of change in Eastern Europe should bolster growth opportunities for the United States, although immediate export potential will be modest. Changes in the Soviet Union could accommodate significant reductions in the defense burden, although such changes may also raise uncertainty in financial markets.

(4) Fiscal policy has taken some unexpected turns. Defense spending projections have been scaled further downward, and the overall deficit picture began to look somewhat brighter toward the end of 1989. However, Senator Moynihan (D-NY) has proposed rolling back the 1990 social-security payroll-tax increase to prevent the current surplus from being used to fund other government programs. This year's budget debate will be arduous.

Our view of the U.S. economy remains relatively unchanged from October. We expect no recession, although growth in the first part of 1990 will be slow. In fact, we have downgraded growth prospects in the second quarter, which will hold average real GNP growth below 2% during the first half of this year. We still expect interest rates to move lower in the first half of 1990, although the Federal Reserve has been very cautious in lowering its target for the federal funds rate.

Policy Assumptions

Fiscal Stalemate? The Bush administration has submitted a budget for fiscal 1991 that formally complies with the Gramm-Rudman deficit target of \$64 billion. The actual deficit for fiscal 1991 is likely to be closer to \$140 billion—about the same level estimated for the current fiscal year.

Defense spending is slowing, and real declines averaging 3-4% per year seem likely during the next four to five years. Any "peace dividend," however, has already been claimed in demands for higher spending

on child care, education, drug control, infrastructure, and the environment. Consequently, it remains to be seen how much federal spending growth will actually slow. An increase significantly larger than the 3% shown in the administration's 1991 budget seems likely.

On the revenue side, early reports for the current fiscal year indicate a sizable slowing in tax receipts, as corporate profits have weakened. Senator Moynihan released a bombshell with his proposal to cut social-security taxes. Although the Bush administration and some key Democrats oppose his plan, the financing of social security has now been opened as a key issue for 1990. A cut in the capital-gains tax, advocated by the administration, will again be considered this year and could emerge in a compromise package.

Fed on the High Wire. The Federal Reserve continues its delicate balancing act between fighting future inflation and maintaining current economic growth. Since last spring, it has gradually reduced its target for the federal funds rate from a peak of nearly 10% to 8.25% at year-end 1989. Its strategy during recent months has been to make a small cut in the rate (25 basis points) and then wait to assess the impact.

We believe that three more quarter-point reductions in the funds rate will occur by midyear as the soft economy puts downward pressure on market interest rates. The growth of the monetary base (currency and bank reserves) is likely to pick up to over 5% this year and in 1991 from the very low rate of about 3% in 1989.

The Federal Reserve remains highly committed to reducing inflation over the next five years. Even though a zero inflation target may not be achieved, monetary policy is likely to restrain the growth of total spending in the economy. Several members of the Federal Reserve Board see the economy's real growth potential as only about 2.5% a year and may attempt to keep actual growth close to that perceived noninflationary limit.

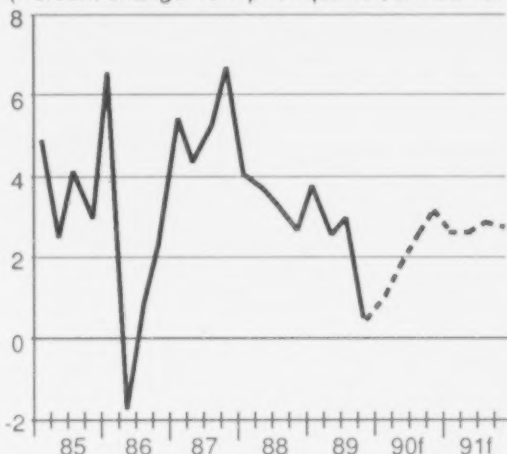
Positives Slightly Outweigh Negatives in 1990

We look for a relatively modest gain of 2.2% in real GNP this year (fourth quarter to fourth quarter). The nonfarm economy is expected to expand somewhat faster this year than in 1989, and second-half growth is expected to be about double that of the first half. The higher growth at about long-run potential is forecast to continue in 1991, with 2.7% real GNP growth next year.

Sources of Strength. The two major forces supporting U.S. economic growth in 1990 will be a more accommodative monetary policy and a continued sizable demand for American exports. A pickup in monetary growth should bolster spending in general,

with at least modest increases in consumer expenditures, housing, and capital outlays. Both consumer and capital-goods producers should realize moderate export gains in 1990, as growth in Europe, the Far East, and Mexico will be relatively strong.

Real GNP Growth Slow, but No Recession
(Percent change from prior quarter, annual rate)



Consumer spending will rise in line with incomes in 1990. A total of 14.4 million cars and light trucks are likely to be sold, about equal to the 14.5 million total of 1989. Lower interest rates are expected to produce somewhat faster vehicle sales in the second half of this year, and total sales in 1991 should rise about 6%. The prevalence of 60-month auto loans and the greater durability of cars are likely to constrain the potential for new-car sales.

We continue to believe that 1989 marked the low point for the housing cycle nationally. The rise in 1990, however, is likely to be modest with an increase to 1.43 million housing starts from 1.37 million in 1989. Builders are concerned about the new restrictions on the amount that can be lent to a single borrower by savings and loan institutions.

For 1991, we forecast that 1.54 million housing units will be started. This level contrasts with 1.81 million units built in 1986, before demographics of the aging "baby-boom" population began to limit the number of new units. Most builders are focusing on the "move-up" as opposed to the "first-time" buyer.

Business capital spending should pick up by the second half of 1990 with some improvement in profits and the ongoing efforts of companies to improve labor productivity, inventory control, and other operating efficiencies. Energy companies plan to conduct a significant amount of oil and natural gas drilling this year. Investment in infrastructure should also be sizable. Finally, the commercial aircraft business continues to boom, with strong orders for new planes as

well as rehabilitation of older equipment.

Constraints in the 1990 Picture. The fourth quarter GNP numbers indicated a considerable "involuntary" buildup of inventories at the retail and wholesale levels. Although not unduly serious, this accumulation will act to restrain new ordering and production in the first part of this year.

In the area of nonresidential building, the oversupply of offices, hotels, and other commercial space in many locations will limit new construction in the current year. Defense spending will be down, affecting both primary contractors and their many subcontractors. The deteriorating fiscal positions of a number of state and local governments are prompting tax increases, which will negatively affect growth in those areas.

On a more "micro" level, financial institutions appear to generally be tightening credit standards, which could limit growth of higher risk or marginal businesses. Various firms that have become highly leveraged also will be cutting back spending in an effort to make interest payments.

Impact on Jobs and Profits. Job growth is likely to slow in 1990 as companies attempt to improve profit margins and adjust to a moderate pace in overall sales and shipments. We expect the overall unemployment rate (including the military) to rise from 5.2% in January to about 5.6% in the third quarter. The jobless rate would then drift slowly back to about 5.1% by the end of 1991.

The manufacturing sector weakened through most of 1989 with a loss of 300,000 jobs between the peak in March 1989 and January 1990. The weakest segments have been autos, computers, and their supplier industries. With the exception of aircraft, most other manufacturing industries were essentially flat in terms of new orders, production, and employment as 1990 began. Many furloughed auto workers have already been recalled, but a number of auto plants will see temporary or permanent closure this year. Hiring in other manufacturing industries is likely to be slow in 1990, although conditions should gradually improve as the year progresses.

Meanwhile, employment growth has continued almost unabated in the broad service sector. A squeeze in profit margins for retailers and service businesses is, however, expected to slow the pace of employment gains in 1990.

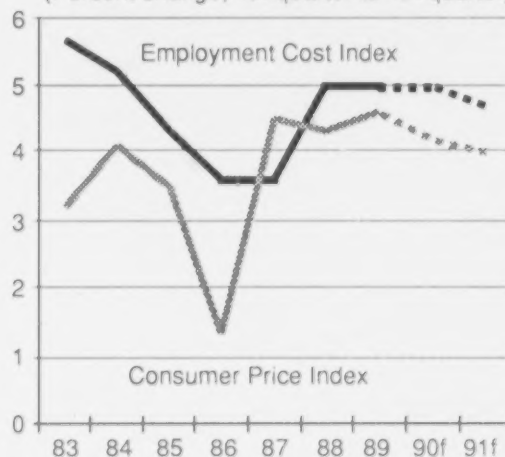
Profit margins fell to recession levels last year but should gradually improve in 1990. Many companies faced rising labor costs (especially for health insurance and other benefits) as well as higher average interest expense. At the same time, product demand was not strong enough to pass on those cost increases. Lower average interest rates, a slowdown in new hiring, and a

pickup in general economic activity in the second half of 1990 should begin to help the profit picture later this year.

Inflation—Slower Trend

As widely quoted in the press, inflation last year was the highest since 1981. Although technically correct, the thrust of these statements was misleading. Consumer prices did increase 4.6% on a year-end to year-end basis in 1989, but this was actually little changed from the 4.4% inflation rate of each of the prior two years.

Price Increases to Moderate
(Percent change, 4th quarter to 4th quarter)



The bitter cold at the end of 1989 increased demand for energy substantially while cutting the supply of various winter crops. The result will be sizable energy and food price increases in the first part of 1990, which could send consumer prices up at an annual rate of about 5.6% in the first quarter of the year. Subsequent actual declines in food and energy prices should dampen inflation in the spring and summer to an annual rate of less than 4%.

The impact of the swing toward tighter monetary policy during the past two years should be an easing of basic inflationary pressure this year and next. Consequently, we continue to expect that consumer prices will be up about 4.2% this year and 4.0% in 1991.

Total employee costs rose 5.0% last year, and a similar rise appears likely in 1990. We are forecasting an increase of 4.7% in 1991. These numbers are slightly above our projections of last fall. Health-care costs show no sign of slowing, although a reduction in social-security taxes would moderate the rise in labor costs.

Interest Rates—Still Lower

We believe that interest rates will decline further towards a trough around midyear. The pace of economic growth will be the most important force affecting the trend of short-term rates. Weakness in the economy will push market rates lower and will also encourage the Federal Reserve to be more expansive and reduce its target for the federal funds rate. We look for the funds rate to fall to a low of about 7.5% by midyear from 8.25% in early February. The prime rate is likely to fall from 10.0% in February to at least 9.5%, and possibly 9.0%, by around the middle of the year.

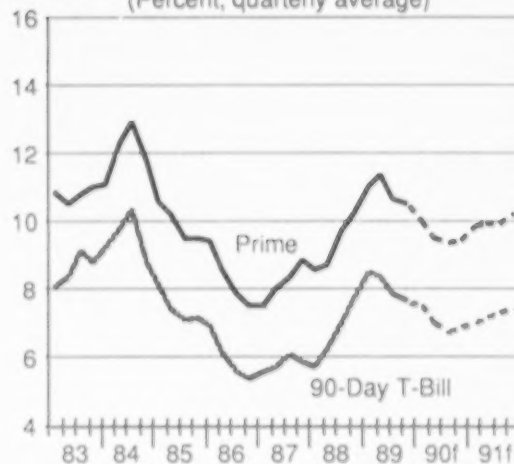
A pickup in economic growth would then push short-term interest rates gradually higher in the second half of 1990 and through 1991. The fed funds rate would average about 7.75% in the fourth quarter of the year and 8.45% in the final quarter of 1991. The bank prime rate would be 9.5% at year-end and 10.0% during most of 1991.

Long-term interest rates leaped higher in early 1990. From an average of 7.9% in both November and December, 30-year government bond yields surged to about 8.5% in early February. A number of factors may have contributed to this increase. These include inflationary concerns, fueled by a recent pickup in monetary growth and hikes in food and fuel prices, and renewed uncertainty about federal tax and spending policies. International forces have probably been more important, with increases in interest rates in Germany and Japan the dominant factors.

With real economic growth in the United States of only about 2% and inflation of close to 4%, a long-term bond yield of 8.5% would seem unsustainable. Partial removal of the uncertainty premium in Japanese long-term interest rates after the recent parliamentary election could help to reduce long-term interest rates in the United States. Consequently, we believe that 30-year

bond rates will move down to 8% or slightly below by the middle of this year. The long-bond yield is likely to stay close to 8% during the latter part of 1990, edging up to only 8.20% by the end of 1991.

Short-Term Interest Rates to Fall Further
(Percent, quarterly average)



While many savings and loan institutions have cut back lending and sold assets to meet new capital requirements, no major increase has occurred in the spread of 30-year fixed-rate mortgages over 30-year government bonds. Other lenders and investors have taken up the slack. An easing in 30-year bond yields should therefore also produce some reduction in mortgage rates from the nearly 10.25% level in early February. We are forecasting that mortgage rates will ease to a low of about 9.8% by the middle of the year and stay below 10% through the balance of 1990. Mortgage rates would then inch back to about 10% by the middle of 1991.

FORECAST OF INTEREST RATES

(Quarterly averages)

	1989				1990				1991			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term												
	Actual				Forecast							
Fed Funds (Overnight)	9.44	9.73	9.08	8.81	8.17	7.68	7.63	7.78	7.98	8.19	8.32	8.44
Treasury Bills (3-month) ¹	8.54	8.41	7.84	7.65	7.61	7.07	6.80	6.92	7.10	7.25	7.38	7.50
CDs (3-month, secondary)	9.60	9.58	8.73	8.44	8.13	7.63	7.64	7.81	8.02	8.25	8.39	8.51
Eurodollar (3-month)	9.69	9.66	8.79	8.49	8.18	7.68	7.71	7.89	8.11	8.34	8.48	8.60
Prime Rate	10.98	11.35	10.66	10.50	10.04	9.57	9.38	9.50	9.92	10.00	10.00	10.25
Long-Term												
U.S. Government Bonds (30-yr) ²	9.04	8.71	8.12	7.93	8.34	8.03	7.98	8.00	8.05	8.10	8.15	8.20
Corporate Aaa (Moody's)	9.69	9.49	8.97	8.89	9.16	8.30	8.82	8.81	8.84	8.88	8.92	8.97
Mortgage Rate (Fixed) ³	10.80	10.67	10.00	9.82	10.09	9.87	9.82	9.84	9.89	9.94	9.98	10.04

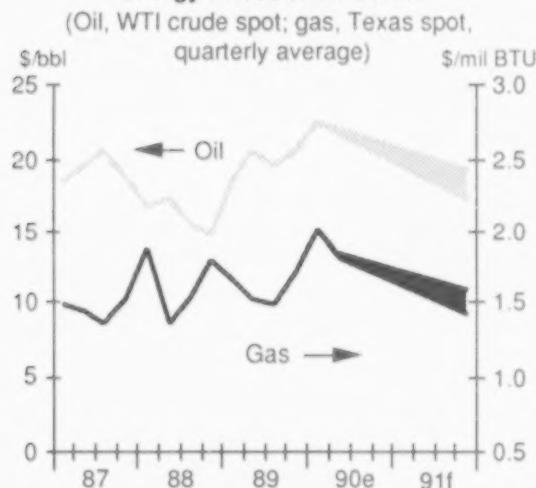
(1) Bank discount basis (2) Yields adjusted to constant maturities (3) Contract rates on first mortgages, conventional market

Industry Perspective

Oil Prices—Temporary Surge. In late 1989 and early 1990, the price of West Texas Intermediate (WTI) crude oil rose above \$20 a barrel. Several factors have been at work: the United Arab Emirates has suffered some production problems; the winter has been exceptionally cold; economic activity in much of the industrialized world has been robust; and major OPEC producers have not produced greatly in excess of honored quota assignments.

Most likely, oil producers' good luck will not run much longer. Prices for future oil delivery reflect market anticipations of a drop in prices of 10% by this fall. If oil prices do begin to decline, a rapid drawdown of crude inventories could trigger large price reductions; a temporary decline to below \$16 should not be surprising. The impetus for such an initial price decline might be warmer weather and slow growth in U.S. industrial output, which would induce a relative slowdown in the economies of some U.S. trading partners.

Energy Prices to Moderate



Even without a significant industrial-country economic slowdown, the possibility of large increases in OPEC production remains ever present. Iraq, in particular, is widely reported to be rapidly rebuilding its production capability, and we may see efforts to "discipline" above-quota producers through temporary surges in output. Finally, exploration and drilling technology continues to reduce the cost of extracting fossil fuels, even as increased concern over environmental issues threatens to constrain the burning of those fuels. The very large conventional oil and gas reserves of OPEC and elsewhere mean that upward price excursions have little chance of persisting.

In view of these considerations, we expect world oil prices to decline from current levels and for the benchmark WTI price to average \$17-\$19 for 1990-91. At

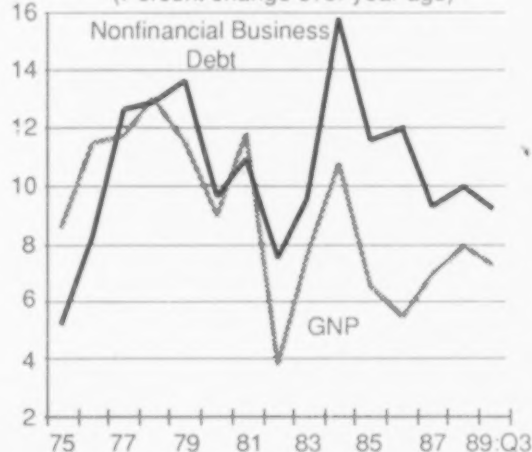
these levels, U.S. oil production will continue to decline, though we forecast domestic exploration activity and natural gas production to rise modestly from current levels.

LBOs—How Vulnerable? Market reaction to the Campeau bankruptcy and the failed UAL takeover attempt, as well as indications that Japanese banks may have lost some of their appetite for risky U.S. debt, have focused increased attention on the leveraged-buyout market.

Federal banking regulators are paying greater attention to loans for "highly leveraged transactions" (HLT) and, thus, possible additional risk in bank portfolios. As a first step, banks are being required to report the volume of HLT loans in their portfolios, a requirement that raises complex issues of what constitutes HLT assets. LBO activity is thought to be a significant part of the buildup of nonfinancial corporate debt. Several explanations exist for why this type of debt has exploded throughout the economic expansion. These include relaxed restrictions on mergers and acquisitions, new financial tools (including development of the junk bond market), and the implied pro-debt bias in the tax code (the double taxation of dividends, but deductibility of interest expense). Since 1982, the growth of nonfinancial business debt has far outpaced the growth in nominal GNP. During both the 60s and 70s, the growth of debt more closely followed that of nominal GNP growth. The implied risk is that, if the economy slows enough, highly leveraged firms would default on their loans, which could have a ripple effect on the economy and exacerbate the severity of the slowdown.

Debt Continues to Outrun GNP

(Percent change over year ago)



In light of Campeau and similar situations, the financial restructuring of various firms and industries will likely proceed at a less hectic pace and with more caution. Industries that are currently under-leveraged, such as household products, chemicals, and paper, may experience an increase in debt-financed restructuring activity.

Financial Institutions

S & L Restructuring Continues

The savings and loan industry reached another milestone as the decade of the 1980s ended. During the 1980s, 835 S & Ls failed, and the situation reached a peak in 1989 with the failure of 328 institutions. The crisis in the thrift industry during the Great Depression of the 1930s overshadowed the 1980s in sheer numbers, with 1,706 failures. The 80s, however, saw a larger share of the industry in trouble. In banking, by contrast, 1,059 institutions failed in the 1980s (207 in 1989), but the magnitude of the banking panic of the 30s, when 9,508 banks failed (more than two out of five), was far more severe.

The Oversight Board for the Resolution Trust Corporation (RTC)—the federal agency created by the bailout legislation in August 1989 to sell assets of failed S & Ls—announced in January 1990 its “strategic plan” for the agency. This plan will govern how the RTC deals with the assets of the 281 failed S & Ls under its control. The RTC is under a mandate to sell off *as quickly as possible* the assets of the weakest thrifts, instead of waiting for improved market conditions. These institutions have the highest operating losses, the most rapid deterioration of their portfolios, and the worst interest rate/credit risk exposure. An important constraint in accomplishing this goal is the stipulation in the bailout legislation that the RTC should obtain 95% of appraised market value in “depressed areas.” “Stronger”—though insolvent—thrifts will be limited to low-risk lending and investing until buyers can be found.

A published list of 30,000 properties to be sold indicates that they are mostly in states that have been hard hit by low energy prices—Texas (over 15,000), Louisiana (over 2,400), and Colorado (nearly 1,600). The great majority of foreclosed properties are residential (nearly 27,000), with 2,500 commercial properties and nearly 800 parcels of land also up for sale. As though the monumental size of the RTC’s immediate task were not overwhelming enough, the number of thrifts under its control is likely to exceed 700, with \$300 billion in assets.

The thrift crisis will negatively affect the economy and financial markets during 1990-91 in several ways. The approved \$50 billion cost to the Treasury will likely be exceeded, and the additional financing required will worsen the federal budget deficit problem. To the extent that “dumping” of thrift assets occurs, real estate prices in regional markets will take longer to recover. With fewer S & Ls making new mortgage loans, other lenders—especially banks—have found opportunities to increase market share. Ultimately, deposit insurance reform will need to be addressed—to remove the moral hazard (encouraging high risk-taking without penalties) and to reduce taxpayer exposure.

Banks In Turmoil

In 1990, many of the nation’s largest banks will continue their restructuring in order to cope with a tougher competitive environment. Their long-term strategies will consider: (a) the emergence of stronger European banks as “EC 92” (the single market in Western Europe) becomes a reality; (b) the activation of national trigger laws in 1991-92, making nationwide banking in the United States closer; and (c) higher capital requirements by 1992 in accordance with the Basel Agreement’s risk-weighting of assets.

The challenge of EC 92 has focused attention on the restrictiveness of American banking laws and the extent to which U.S. banks operate at a competitive disadvantage. In several EC countries (West Germany in particular), varying degrees of the “universal banking” system allow the intermingling of banking, securities, and insurance. It is unlikely, however, that Congress will enact legislation as early as 1990-91 to abolish or amend the Glass-Steagall Act, and the initiative will remain with regulators to ease restrictions on bank entry into the securities business.

The McFadden Act, which prohibits interstate banking, has been increasingly eroded in the 1980s by technology, regulatory actions allowing acquisitions, and changed state laws. In 1991, when banks based in any part of the nation can acquire California banks, another major hurdle standing in the way of nationwide banking will be overcome. This development will virtually assure equal treatment between the United States and the EC, which has already ruled that American and other non-EC banks can operate in any EC country with a single banking license from one member nation.

Problems in three areas of the loan portfolio will continue to plague banks in 1990-91. Debt exposure to less developed countries (LDCs) prompted some of the nation’s largest banks to make additional reserves for possible losses on loans to LDCs. While most of the large banks now have adequate reserves, a few very large institutions are still perceived by the market to be under-reserved for LDC loans.

Leveraged buyout (LBO) loans of a few banks also constitute a growing source of concern to regulators. As of mid 1989, 11 of the largest bank holding companies had a combined volume of \$32.2 billion classified as LBO loans, a 17.5% increase over year-end 1988 levels and representing nearly 81% of common equity capital. Non-performing real estate loans mushroomed into an issue of great concern in 1989, with some large banks in the Northeast, the South, and the West showing a doubling of such loans in the first nine months of the year. With softness in most regional real estate markets expected throughout 1990, this component of bank loan portfolios is likely to continue receiving the attention of regulators and analysts.

First Interstate Territory

The 19 states that comprise First Interstate's banking territory (affiliates and licensees) recorded aggregate income and employment growth rates matching national averages in 1989. The region should slightly outperform the rest of the nation in 1990 and 1991.

Pacific Southwest—Basics Still Strong

The Pacific Southwest (Arizona, California, Hawaii, and Nevada) showed a combined employment gain of 3.2% in 1989, and we forecast an increase of 2.2% for 1990. Although influenced significantly by national trends in such industries as tourism and manufacturing, these growth rates compare favorably with the U.S. numbers of 2.8% and 1.5% for the two respective years.

Nevada's boom will ebb somewhat, California's and Hawaii's growth rates will moderate, but Arizona will see higher job growth than during the past two years. Lower defense spending will temper California's growth, while Arizona works through its real-estate overhang. The office vacancy rate in Phoenix has moved up sharply to 26% (end 1989) from 17% in the latter part of 1988. Each of these four states, however, should post job and income gains above the U.S. averages in 1990 and 1991.

Pacific Northwest—Growth Leader

The Pacific Northwest (Alaska, Idaho, Oregon, and Washington) posted the fastest income and job growth in the territory in 1989 and that outcome may be repeated in 1990, albeit with only a small margin over the Pacific Southwest. Nonfarm jobs rose a strong 4.5% in 1989 and we expect a gain of 2.3% in 1990. Alaska's economy has turned up again with higher oil prices. Washington's economy remains solid, with record commercial aircraft backlogs at Boeing. Environmental disputes have restricted the supply of logs to the timber industry, but Oregon and Idaho should still realize moderate overall job gains in 1990.

Rocky Mountains—Improving

The Rocky Mountain states (Colorado, Montana, New Mexico, Utah, and Wyoming) have improved, with a job gain of 2.2% in 1989. We look for another increase of 1.6% this year, representing a gain slightly above the national average. Mining (oil, natural gas, and coal) has recently picked up, and farm prices are relatively strong. The growth of high-tech manufacturing and services is bolstering Utah's economy. Defense cutbacks pose some risk to New Mexico and Utah, while Colorado tries to reduce its overcapacity in

offices and other buildings. The office vacancy rate in Denver is still high, 25%, but has fallen from over 30% in 1987.

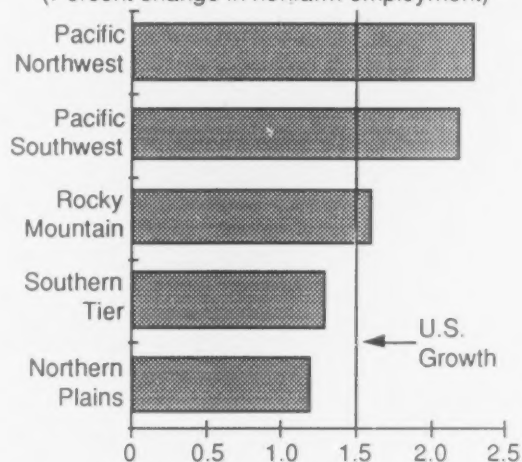
Southern Tier—Recovering

The Southern Tier states (Louisiana, Oklahoma, and Texas) appear to be recovering. Nonfarm payroll jobs rose 1.7% in 1989, and we forecast another 1.3% gain in 1990. Oil prices in the "high teens" (our current forecast) should support a moderate level of oil and gas exploration and development. The new technology of horizontal drilling also holds promise for the region's industry. The Texas economy is growing substantially faster than the other two states because of its greater diversification. While the real estate adjustment continues, businesses and workers will be attracted to the lower land costs and rents, especially in Texas. Oklahoma City continues to have the highest office vacancy rate in the nation, 35%.

Northern Plains—Small Increases

The Northern Plains states (Iowa and the Dakotas) recorded an average gain in jobs of 2.5% in 1989. We anticipate a rise of about 1.2% in 1990. Although drought conditions have adversely affected parts of the region, crop prices are generally good. Increased planting should help suppliers of farm equipment during the current year. However, efforts by the federal government to reduce farm subsidies could constrain future income growth in this region. The general slowdown in the U.S. goods-producing sector in the first half of 1990 will also limit the near-term potential for various small and medium-sized manufacturers in the area.

Western States to Outpace the Nation in 1990
(Percent change in nonfarm employment)



NONFARM PAYROLL EMPLOYMENT

	1988		1989e		1990f		1991f	
	Thousands	% Change	Thousands	% Change	Thousands	% Change	Thousands	% Change
Alaska	212	1.0	220	3.7	225	2.0	227	1.2
Arizona	1,411	1.8	1,437	1.9	1,477	2.8	1,529	3.5
California	12,134	3.9	12,522	3.2	12,773	2.0	13,054	2.2
Colorado	1,426	0.9	1,444	1.3	1,463	1.3	1,488	1.7
Hawaii	477	3.7	493	3.4	506	2.5	516	2.1
Idaho	349	4.6	363	4.2	372	2.5	381	2.3
Iowa	1,156	4.2	1,191	3.1	1,207	1.3	1,224	1.4
Louisiana	1,502	1.2	1,516	1.0	1,531	1.0	1,548	1.1
Montana	279	1.8	282	1.1	285	1.0	288	1.0
Nevada	538	7.5	574	6.7	596	3.9	613	2.8
New Mexico	540	2.1	554	2.5	565	2.0	575	1.8
North Dakota	256	1.2	260	1.6	263	1.1	265	0.9
Oklahoma	1,133	2.2	1,141	0.7	1,149	0.7	1,158	0.8
Oregon	1,152	4.7	1,196	3.8	1,220	2.0	1,247	2.2
South Dakota	264	2.8	267	1.1	270	1.1	272	1.0
Texas	6,647	2.0	6,782	2.0	6,884	1.5	6,987	1.5
Utah	660	3.2	688	4.2	704	2.3	717	1.8
Washington	1,936	4.5	2,035	5.1	2,086	2.5	2,123	1.8
Wyoming	189	3.2	194	2.4	197	1.6	200	1.6
FI Territory	32,259	3.1	33,159	2.8	33,771	1.8	34,411	1.9
U.S.	105,584	3.3	108,582	2.8	110,260	1.5	112,085	1.7

PERSONAL INCOME

	1988		1989e		1990f		1991f	
	\$ Billions	% Change	\$ Billions	% Change	\$ Billions	% Change	\$ Billions	% Change
Alaska	10.0	3.4	11.2	11.8	12.0	7.7	12.9	6.9
Arizona	52.2	7.3	55.7	6.7	59.7	7.2	64.4	7.8
California	531.0	8.1	577.7	8.8	618.7	7.1	664.5	7.4
Colorado	54.4	5.3	58.4	7.4	62.2	6.5	66.6	7.1
Hawaii	18.4	9.2	20.4	10.7	22.2	8.8	24.0	8.3
Idaho	12.7	7.7	13.9	9.6	15.0	7.4	16.1	7.4
Iowa	41.6	4.9	45.4	9.2	48.3	6.5	51.6	6.8
Louisiana	54.2	5.9	58.1	7.2	61.9	6.5	65.9	6.6
Montana	10.4	4.0	11.1	7.3	11.8	6.5	12.6	6.6
Nevada	18.5	12.2	20.9	13.4	23.1	10.1	25.1	8.9
New Mexico	18.8	5.8	20.3	7.8	21.7	6.8	23.1	6.8
North Dakota	8.6	-0.6	9.3	8.5	9.8	5.8	10.4	5.8
Oklahoma	43.2	5.1	46.1	6.6	48.9	6.2	52.0	6.3
Oregon	41.2	8.7	45.0	9.2	48.3	7.4	52.0	7.6
South Dakota	9.1	3.3	10.0	9.5	10.5	5.8	11.2	5.9
Texas	245.6	5.8	265.3	8.0	283.9	7.0	303.8	7.0
Utah	20.6	6.4	22.5	9.4	24.1	7.1	25.8	6.8
Washington	76.6	7.8	84.3	10.2	90.7	7.5	96.8	6.8
Wyoming	6.5	3.8	6.8	4.7	7.2	5.1	7.5	5.1
FI Territory	1,273.4	7.0	1,382.3	8.6	1,479.9	7.1	1,586.2	7.2
U.S.	4,053.0	7.6	4,397.8	8.5	4,692.5	6.7	5,025.6	7.1

Note: Calculations based on unrounded data.

MAJOR ECONOMIC INDICATORS

	QUARTERLY												4th QUARTER					
	1989				1990				1991				% Change 1989 '89'88 Actual		% Change 1990 '90'89 Forecast		% Change 1991 '91'90 Forecast	
	I	II	III	IV	I	II	Forecast	III	IV	I	II	Forecast	III	IV				
GROSS NATIONAL PRODUCT (Billions of \$, annual rate)	5113.1	5201.7	5281.0	5337.0	5411.6	5491.9	5580.4	5680.0	5772.9	5864.5	5961.9	6057.9	5337.0	6.4	5680.0	6.4	6057.9	6.7
% Change, annual rate	7.9	7.1	6.2	4.3	5.7	6.1	6.6	7.3	6.7	6.5	6.8	6.6						
REAL GNP (Billions of 1982 \$, a.r.)	4106.8	4132.5	4162.9	4168.1	4179.5	4198.2	4226.3	4259.7	4288.1	4315.7	4346.7	4376.8	4168.1	2.4	4259.7	2.2	4376.8	2.7
% Change, annual rate	3.7	2.5	3.0	0.5	1.1	1.8	2.7	3.2	2.7	2.6	2.9	2.8						
REAL FINAL DOMESTIC SALES* (Billions of 1982 \$, a.r.)	4140.6	4161.5	4205.9	4201.9	4223.8	4238.7	4262.8	4293.5	4321.1	4348.1	4376.7	4406.1	4201.9	1.8	4293.5	2.2	4406.1	2.6
% Change, annual rate	1.3	2.0	4.3	-0.4	2.1	1.4	2.3	2.9	2.6	2.5	2.7	2.7						
REAL CHANGE IN INVENTORIES (Billions of 1982 \$, a.r.)	24.5	19.1	21.9	32.6	15.5	17.0	20.0	22.8	25.0	26.5	29.0	31.5	32.6	N/A	22.8	N/A	31.5	N/A
GNP DEFLATOR (1982=100)	124.5	125.9	126.9	128.0	129.5	130.8	132.0	133.3	134.6	135.9	137.2	138.4	128.0	3.8	133.3	4.2	138.4	3.8
% Change, annual rate	4.0	4.6	3.2	3.5	4.7	4.2	3.8	4.0	3.9	3.8	3.8	3.7						
CONSUMER PRICE INDEX (1982=100)	121.9	123.8	124.6	125.8	127.5	128.7	129.9	131.1	132.5	133.8	135.1	136.4	125.8	4.6	131.1	4.2	136.4	4.0
% Change, annual rate	5.4	6.4	2.6	3.9	5.6	3.8	3.6	4.0	4.1	4.0	4.0	3.9						
AUTO SALES (Millions, annual rate)	9.8	10.3	10.8	8.7	9.9	9.7	10.0	10.1	10.3	10.4	10.5	10.3	9.9**	-6.9	9.9**	0.2	10.4**	4.4
HOUSING STARTS (Millions, annual rate)	1.52	1.35	1.34	1.33	1.35	1.37	1.49	1.52	1.54	1.54	1.54	1.55	1.37**	-7.7	1.43**	4.3	1.54**	7.5
INDUSTRIAL PRODUCTION (1977=100)	140.7	141.8	142.2	142.3	142.4	142.8	143.6	144.9	146.0	147.0	148.1	149.2	142.3	1.7	144.9	1.8	149.2	2.9
% Change, annual rate	2.3	3.2	1.1	0.3	0.2	1.2	2.3	3.6	3.0	2.8	3.1	2.9						
NONFARM EMPLOYMENT (Millions)	107.7	108.3	108.9	109.4	109.8	110.0	110.3	110.8	111.3	111.8	112.3	112.8	109.4	2.4	110.8	1.3	112.8	1.8
UNEMPLOYMENT RATE, ALL WORKERS (Percent)	5.1	5.2	5.2	5.3	5.3	5.5	5.6	5.4	5.4	5.3	5.2	5.1	5.3	N/A	5.4	N/A	5.1	N/A
CORPORATE PRETAX OPERATING PROFITS (Billions of \$, annual rate)	316.3	307.8	295.2	295.5e	294.0	297.0	302.0	309.0	315.0	320.0	325.0	333.0	295.5e	-13.1	309.0	4.6	333.0	7.8
% Change over year ago	-0.6	-5.4	-10.8	-13.1	-7.1	-3.5	2.3	4.6	7.1	7.7	7.6	7.8						
PROFITS AFTER TAXES (Billions of \$, annual rate)	173.6	161.1	152.4	152.0e	150.0	153.0	158.0	163.0	165.0	168.0	173.0	178.0	152.0e	-13.4	163.0	7.2	178.0	9.2
% Change over year ago	8.6	-3.5	-12.0	-13.4	-13.6	-5.0	3.7	7.2	10.0	9.8	9.5	9.2						
MONETARY BASE (Billions of \$, a.r.)	277.7	278.7	280.8	283.6	287.3	291.2	295.0	298.6	302.6	306.3	310.2	314.1	283.6	3.3	298.6	5.3	314.1	5.2
% Change, annual rate	4.7	1.5	3.0	4.1	5.3	5.5	5.3	5.0	5.5	5.0	5.2	5.1						

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on unrounded data, a.r. = annual rate, e=estimate. *Excluding Commodity Credit Corp. purchases

**Annual total, N.A. = Not applicable



FORECAST

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UPDATE

June 1990

Including Five-Year Projections

First Interstate Territory Edition

 **First
Interstate**
Bancorp

FIRST INTERSTATE BANCORP

BANKING AFFILIATES

Alaska

First Interstate Bank of Alaska

Arizona

First Interstate Bank of Arizona, N.A.

California

First Interstate Bank of California

First Interstate Bank, Limited

Colorado

First Interstate Banks of Denver, N.A.,
Englewood, N.A., and Fort Collins, N.A.

Idaho

First Interstate Bank of Idaho, N.A.

Montana

First Interstate Banks of Glacier County,
Great Falls, and Kalispell, N.A.

Nevada

First Interstate Bank of Nevada, N.A.

New Mexico

First Interstate Banks of Albuquerque,
Lea County, Roswell, and Santa Fe, N.A.

Oklahoma

First Interstate Bank of Oklahoma, N.A.

Oregon

First Interstate Bank of Oregon, N.A.

Texas

First Interstate Bank of Texas, N.A.

Utah

First Interstate Bank of Utah, N.A.

Washington

First Interstate Bank of Washington, N.A.

Wyoming

First Interstate Banks of Casper, N.A.,
Laramie, N.A., Riverton, N.A.

BANK LICENSEES

Colorado

First Interstate Banks of Arvada, N.A.,
Centennial, N.A., Golden, N.A., and
Westminster, N.A.

First Interstate Bank of South Fort
Collins

Hawaii

First Interstate Bank of Hawaii, N.A.

Iowa

First Interstate Bank of Iowa

Louisiana

First Interstate Bank of Southern
Louisiana

Montana

First Interstate Banks of Billings, N.A.,
Billings Heights, Colstrip, Hardin,
Miles City, Missoula, N.A., and West
Billings

New Mexico

First Interstate Bank of Farmington

North Dakota

First Interstate Bank of Fargo, N.A.

South Dakota

First Interstate Bank of South Dakota, N.A.

Wyoming

First Interstate Banks of Buffalo,
Gillette, Greybull, N.A., Sheridan,
and Sugarland

FOREIGN LOCATIONS

Abu Dhabi	Nassau
Bangkok	Rio de Janeiro
Beijing	Seoul
Hong Kong	Singapore
Jakarta	Sydney
Lima	Taipei
London	Tokyo
Madrid	Toronto
Manila	Vancouver
Mexico City	

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Miami New York

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Overview

Early in this decade a new, all-time record for the duration of an economic expansion will be set. We expect the 9-year expansion of the 1960s to be eclipsed at the end of 1991 and the record to be extended through the following four years.

This update of our 5-year forecast is not substantially different from that of a year ago. Inflation is expected to average about 4.0%, with real output growing at a 2.5-3.0% average rate. We have lowered the trading range for long-term government bonds to 7.5-9.0% from the 8.0-10.0% range projected last year.

Average job growth will be slower in the 1990s both because we are now near full employment and because the number of new entrants to the working-age population is declining. At the same time, however, productivity is expected to continue improving, so real output and income will rise as fast as or faster than in the past decade.

Opportunities

Exporting and import-competing industries will continue to experience healthy demand in the years ahead. The political and economic restructuring occurring in Latin America and Eastern Europe presents expanding opportunities for U.S. investment and exports. U.S. capital-goods industries should have considerable opportunities for participating in development of the infrastructure and in cleaning up the environment of Eastern Europe. Foreign demand for new technologies among the newly industrializing economies will provide expanding markets for U.S. firms.

Strong growth sectors of the U.S. economy in the 1990s will include telecommunications and other high-technology firms; pharmaceuticals; commercial aircraft; environmental engineering; commercial aircraft; and the services and products related to the travel/tourism/recreation/entertainment sectors.

Relatively weak sectors will include automobiles, railroads, housing, commercial construction, and defense contracting.

Correcting U.S. Imbalances

National economic problems inherited from the 1980s include the S & L debacle, the federal budget deficit, and the foreign-trade deficit. To some extent, these are interrelated and finding a solution to one will help with the others. The federal budget deficit peaked at \$221 billion (5.3% of GNP) in fiscal 1986. After falling in 1987-89, the deficit is rising in fiscal 1990, but will resume falling to under 2% of GNP by 1995.

The merchandise-trade deficit peaked in 1987 at \$159 billion (3.5% of GNP) and is now forecast to be \$103 billion (1.9% of GNP) in 1990. After a modest rise in

1991, the trade deficit should decline through 1995.

The total cost to taxpayers of resolving the problems of the S&L industry has been revised up several times. Nevertheless, disposition of real estate assets and closing of under-capitalized institutions are expected to be completed during the coming five years.

Risks from Abroad

One of the major challenges of the early 1990s will be the inevitable asset deflation in Tokyo. A further decline of equity prices and a significant drop in real estate prices in Japan will be necessary in order to restore relationships to output prices and income levels that are closer to those observed in other economies.

The economic unification of the Germanys will be a great burden to the West German taxpayer/consumer. The potential for a policy mistake that generates accelerating inflation is too great to be ignored. The "anchor" role of the deutschmark in the European Monetary System has been crucial to the generally good inflation results in Europe in recent years, and loss of confidence in this key currency would be negative for Europe's medium-term growth prospects.

The medium-term outlook also is vulnerable to the possibility of spreading violence in the breakup of the Soviet bloc. In both Eastern Europe and the Soviet republics there is risk that ethnic strife and nationalism could precipitate violent clashes.

Challenges

The 1990s will be marked by a substantial increase in resources devoted to addressing long-neglected environmental problems. Improving the quality of education will also be a top priority of the decade. Economic rivalries among political allies will focus attention on the relative performance of educational institutions. An overdue restructuring of the U.S. public school system will finally occur in the 1990s.

—June 15, 1990

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The International Economy

Near Term

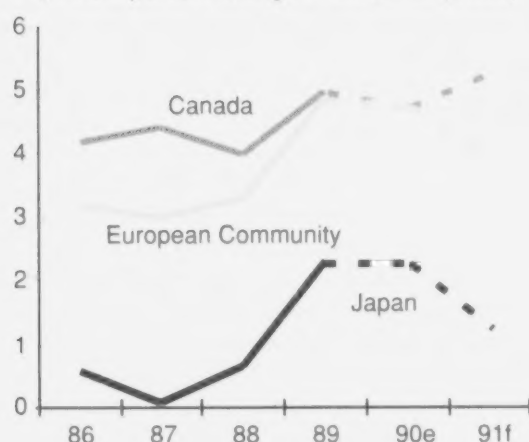
Anti-Inflation Policies in Industrial Countries

Economic growth has remained strong in most industrial countries. At the same time, however, the rate of inflation has edged upward in several countries, and monetary authorities have gradually tightened policies. Late in 1990 and in 1991, these tighter monetary policies are expected to lead to a gradual slowing of economic growth, but growth will still be relatively high by the standards of the 1980s.

The pattern of economic growth varies among the major industrial countries. Japanese real GNP growth, at around 4% in 1990, will be slower than last year's 4.9%. Nevertheless, despite the recent fall in Japanese equity markets, both investment and consumer spending are expected to remain strong this year. Inflationary pressure has increased, and the Bank of Japan has responded by increasing interest rates. This is one factor behind declining equity and real-estate prices in Japan.

Moderate Inflationary Pressure

(Annual percent change in consumer prices)



European growth, on average, shows no sign of slowing, although the United Kingdom is an exception. Nevertheless, added to the already strong impetus created by the 1992 market unification, the unification of Germany (which, in economic terms, will occur on July 2) is fuelling growth in Europe's largest economy. Real GNP this year should rise at a rate close to both that of Japan this year and Germany's own 4% rise last year. Although financial markets reflect some concern that currency unification in Germany will be inflationary, it is expected that the annual rise in consumer prices will not exceed 4%.

Continued rapid growth in the continent's largest economy will be one more factor keeping growth in

other European countries well above the levels recorded in the 1980s. Growth in most of Europe had already accelerated for a number of reasons: (1) deregulation and tax reform on the part of national governments; (2) industrial restructuring; (3) lower inflation; and (4) the prospect of a unified market after 1992.

Interest rates in most markets have risen in response to tighter monetary policy, higher inflation, and rising fixed capital formation. While the relationship between interest rates in different markets is complex, the basically free flow of funds that now characterizes industrial-country capital markets means that rates are strongly linked. To the extent that interest rates in Europe and Japan—the largest sources of financing for the U.S. current-account deficit—remain high, U.S. rates will be higher than otherwise. At present, it appears likely that German rates will remain fairly high throughout 1990 because of both higher real rates of return on capital and inflation concerns, while Japanese interest rates are unlikely to fall much unless turbulence in equity and real-estate markets prompts the Bank of Japan to lower short-term rates.

The Japanese trade and current-account surpluses recorded fairly large declines in 1989, with the current-account surplus falling to \$57 billion from \$80 billion the previous year. Despite weakness of the yen in early 1990, a further decline is likely in 1990 to approximately \$52 billion. West Germany's surplus, \$53 billion in 1989, should increase in 1990, although a change in the statistics will result from consolidation of East Germany in the second half.

World Trade Expansion Continues

World trade, measured by imports, should continue to expand during 1990, its eighth year of expansion since the 1982 worldwide recession. It is clear that world trade is expanding at a faster rate than real economic growth alone would indicate, a result of increasing world economic integration. Its growth, however, will slow substantially on a volume or inflation-adjusted basis from 1989 rates, while it will increase more rapidly in nominal or inflation-unadjusted terms.

WORLD TRADE

(Imports, percent change)

	1987	1988	1989e	1990f	1991f
Volume	6.5	8.9	7.6	5.5	6.0
Nominal	17.1	14.4	7.8	9.7	11.5

The slowdown in volume growth reflects the second consecutive year of slower real economic growth. We estimate that industrial-country growth will decrease to about 2.6% in 1990 from 3.4% in 1989 and 4.5% in 1988. During 1990, we expect import

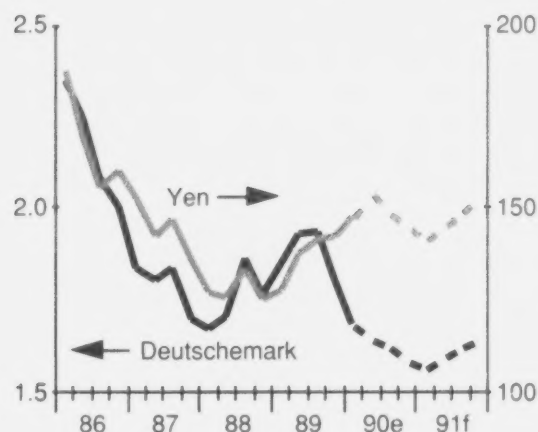
prices to rise about 4%, up from an approximately 0.2% increase in 1989, which was a sharp decline from 5.1% in 1988. For 1991, we look for trade to expand more rapidly as the world economy shakes off the slowdown of 1990.

Further Changes in Indebted Countries

A new government in Brazil, the largest developing-country debtor, has instituted a severely deflationary plan, accompanied by a program of structural reforms. While the drastic reduction in liquidity entailed by the plan has had an immediate effect on Brazil's hyperinflation (prices rose more than 5000% in the year to March), the outlook remains dependent on the success of structural reforms. These include significant reductions in the size of government, privatization of state enterprises, liberalization of foreign trade, and more openness to foreign investment. The outcome will affect not only the course of the Brazilian economy during the 1990s, but also the earnings of large U.S. banks with loans to Brazil.

Elsewhere, some positive signs are emerging. Chile has successfully moved toward democratic government, with the new government unlikely to derail successes in economic policy. In Mexico, the proposal by the government to reprivatize most commercial banks has reinforced confidence in the commitment to freer markets. In Venezuela, a debt agreement has been reached with commercial bank creditors, adding to confidence that the government will continue to foster a more competitive, open economy.

Dollar Depreciates through Year-end
(Units per dollar, quarterly average)



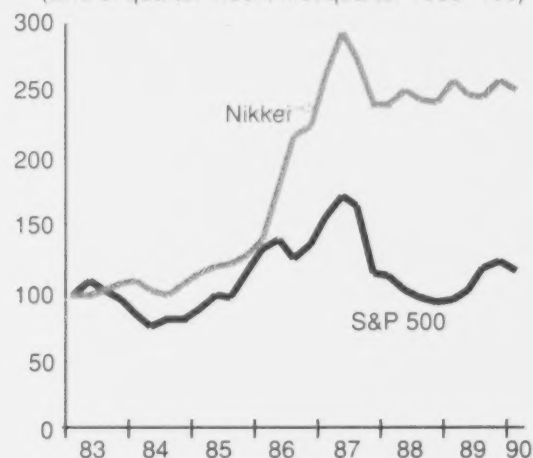
Dollar to Weaken During Remainder of 1990

During the first four months of 1990, the dollar strengthened substantially against the yen while it weakened against the deutschmark. The large correction in the Tokyo stock market, in which the Nikkei

index lost 28% percent of its value from its peak at end 1989, caused the yen to depreciate sharply against other industrial-country currencies. (By end May, Japanese stocks had regained almost half of that loss.) Simultaneously, world markets were convinced that West Germany was well positioned to take advantage of political and economic developments in East Germany and in Eastern Europe, resulting in a sharp appreciation of the mark.

Our forecast is for the dollar generally to depreciate against other industrial-country currencies during the remainder of 1990 as the differential between U.S. and foreign interest rates narrows. We look for the dollar to depreciate 8% against the yen from its estimated second-quarter-1990 average through first quarter 1991, after having appreciated nearly 24% from fourth quarter 1988 through second quarter 1990. From first quarter 1991, we believe the dollar will appreciate 8.5% through fourth quarter 1991, as U.S. short-term interest rates rise. We expect the dollar to depreciate less against the mark than against the yen—7% from first quarter 1990 through first quarter 1991—and then to appreciate 5% during the following three quarters.

Price/Earnings Ratios--Nikkei and S&P 500
(End of quarter index, first quarter 1983=100)



During the remainder of 1990, there are at least two reasons why the dollar should weaken against the yen. Not only do real interest-rate differentials play a major role, but past and continuing heavy Japanese domestic investment implies that Japan's comparative advantage in traded goods will not erode; in fact, it may well strengthen. A possible threat to the yen comes from the Tokyo stock market and Japanese land values, however. In comparison to other industrial-country stock markets, Tokyo stocks are overvalued. If price/earnings ratios were more equal among international markets, the Nikkei would be closer to 20,000 as opposed to 32,000, let alone its peak of 38,915 at end 1989. In addition,

Japanese land values, especially in major metropolitan areas, are substantially inflated.

The Bank of Japan (BoJ) has voiced concerns about both stock market and land values and the nature of a correction in either market: Will the bubbles burst as opposed to being slowly deflated? Moreover, what would the effects of a correction be? BoJ is concerned that not only would a sharp correction in either market hurt Japan's economic and financial systems, it would also generate serious problems elsewhere in the world. Nevertheless, BoJ believes that a correction is necessary. Too rapid a correction in either market would lead to substantial weakness in the yen.

The Bundesbank is likely to pursue monetary policies that will minimize inflation pressures resulting from German reunification. As a consequence, German interest rates will remain high, helping to support the mark. A near-term threat to the mark is the upcoming December elections. The markets would likely interpret a rejection of the Kohl government as unfavorable for the mark.

U.S. Current-Account Deficit To Shrink

The U.S. current-account deficit ballooned to \$144 billion in 1987, the equivalent of 3.2% of GNP. Since then, the current-account deficit has been declining.

Our forecast for 1990 is for merchandise export growth to slow from the 1989 rate, but to remain above the growth of imports. The slowdown in U.S. real economic growth during second half 1989 resulted in decreased import growth. Export growth has slowed because the easy gains that followed the large depreciation of the dollar engineered in the mid 1980s have been exploited.

U.S. CURRENT ACCOUNT

(Billions of dollars)

	1987	1988	1989	1990e	1991f
Trade balance	-159.5	-127.2	-113.2	-106.8	-112.4
Exports	250.3	319.3	361.9	394.4	428.0
Imports	-409.8	-446.5	-475.1	-501.3	-540.3
Services balance	30.0	15.3	21.6	19.6	16.7
Service exports	195.9	210.6	238.5	255.2	276.0
Service imports	-165.9	-195.2	-216.9	-235.6	-259.4
Transfers balance	-14.2	-14.7	-14.3	-15.5	-16.3
Official	-10.2	-10.4	-10.2	-10.5	-10.8
Private	-4.1	-4.3	-4.0	-5.0	-5.5
Current-Account balance	-143.7	-126.5	-105.9	-102.7	-112.0

Exports to Europe should be strong during 1990 because of the depreciation of the dollar against European currencies, led by the mark. At the same time, the dollar has strengthened against the yen and several other Asian currencies because of the underlying threat from

current Japanese stock and land values. The South Korean government has depreciated the won in an attempt to boost Korean exports and curb imports. Taiwan has also recently depreciated its currency against the dollar. U.S. export growth to Asia could be restrained somewhat by the dollar's relative strength.

Our forecast includes a trending downward in the services surplus. The deterioration in the U.S. net investment position, signaled by continuing current-account deficits in excess of \$100 billion annually, implies a continuing erosion. Unless the current U.S. slowdown is more pronounced and of longer duration than we are forecasting, we do not foresee a large decline in the current-account deficit.

Medium Term

Issues in the Industrial-Country Outlook

In general, the outlook for the industrial countries during the first half of the 1990s is quite positive compared with the performance of the 1980s. Some factors leading to this assessment include:

(1) Fiscal policies. By 1989, central government budget deficits as a percentage of GNP had been brought down to 2.5% in the major industrial countries, compared with an average of 4.0% during the preceding five years.

(2) Monetary policies. The growth of M1 in the same group of countries averaged 8.3% annually during the 1984-88 period, but there was a declining trend in evidence. In 1989, M1 grew by 3.1%, indicating some restrictiveness, but broader aggregates grew fairly steadily.

(3) Inflation. Despite a recent rise in inflation, the average in the major industrial countries remains below 5%, and there seems little reason to expect it to rise above this level.

(4) Investment. Fixed investment as a percentage of GNP has risen in the major industrial countries, particularly during the past three years. Further structural changes in Europe and Japan make it likely that investment growth, although slowing, will remain relatively strong.

Some issues in the global outlook for the early 1990s include, first, the international monetary environment. It is possible that the European Community (EC) will introduce a single currency during the coming five years. Such a development would clearly challenge the role of the U.S. dollar as the linchpin of the global monetary system. This would mean, among other things, an increase in external discipline on U.S. monetary policies.

Second, the emergence of a more competitive European economy—with or without monetary union—is already well under way. Within the past three years, Europe has become much more dynamic than during

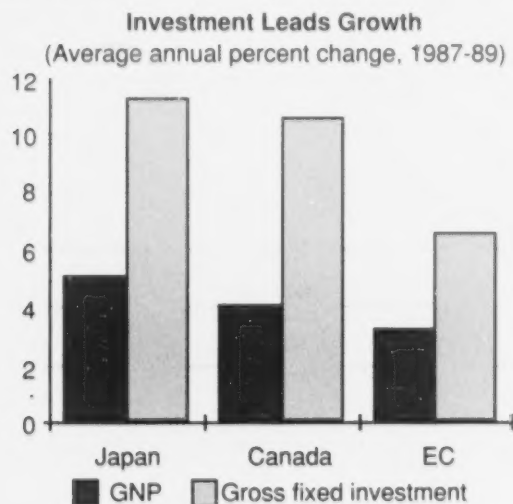
the first part of the 1980s, and an integrated Europe will be a formidable economic power during the 1990s.

Third, the integration of Eastern European countries into the global economic and financial system will provide opportunities for investors and increase the volume of trade. However, except for the immediate impact of German unification on the German economy, these effects will emerge only gradually.

It is important to point out, however, the possibility of a failure of economic reform in the Soviet Union, which could set off political changes that would unsettle Western markets. Among the effects of such a development could be a strengthening of the dollar, smaller cuts in defense expenditures, and less investment in Eastern Europe. Higher interest rates in Western Europe could have a detrimental effect on growth.

A fourth factor that may be significant in the global economy is the recent proposal for a Mexico-U.S. free trade agreement. While the integration of two such different societies and economies appears unlikely in the near future, the prospect of a North American free trade area (including Canada) would clearly affect global investment patterns. With a population of 84 million, Mexico would be a significant addition to the U.S.-Canada free trade area, adding a new dimension to the competitive position of North America.

Finally, the impact of economic developments in Japan on global trade and investment must be considered. While the Japanese outlook remains in general fairly favorable, based on continued high levels of investment and a shift toward more rapid increases in consumption, financial and equity market imbalances could affect both the domestic economy and financial markets abroad.



Trade Growth to Remain Strong

During the medium term, the enhanced trade growth resulting from increasing economic integration

should accelerate. In addition, the growing presence of the European Community (EC) as it evolves toward its 1992 target should result in increased trade flows, especially among the twelve members. The pickup in trade within the EC does not, however, imply that trade between the Community and the rest of the world will diminish.

In developing Asia, trade should continue to expand. With Thailand and Malaysia, and possibly Indonesia, now constituting the countries on the second tier of Asian Newly Industrializing Economies (NIEs), more of the area's population is located in a dynamic, trade-oriented region. Political and economic problems in the People's Republic of China, however, may imply considerably less dynamism in China and, as a result, in Hong Kong.

Mixed Exchange-Rate Trends

During the medium term, Japan has agreed to pursue policies that could lead to a correction in land values. The factors that contributed to the run-up in stock prices and asset values in recent years include low-inflation policies following the second round of oil price hikes (1979), the decline in energy prices following the worldwide recession of 1982, and increasing current-account surpluses during 1981-87, which resulted in the appreciation of the yen and kept inflation lower than otherwise. With current-account surpluses tending to decline, energy prices trending upward, and inflation rates rising, there is considerable longer-run downward pressure on the stock market and land values, which would cause the yen to depreciate to the 160-180 level.

We expect the mark to remain strong during 1990-95. Germany's large current-account surplus will diminish considerably as the economy of what is now East Germany is upgraded. Nevertheless, Germany will remain the dominant player in the EC and a leader as Eastern Europe reforms itself. Negative developments in the Soviet Union affecting the outlook for Eastern Europe would affect the mark adversely. On the other hand, a relatively peaceful disintegration of parts of the Soviet Union—independence for the Baltic republics, for example—would tend to keep the mark strong.

U.S. Trade Deficits Stay Large

A U.S. economy experiencing no recession during 1990-95 implies substantial trade and current-account deficits, although down from their peak levels. Export growth will continue, but it will be because of hard work and increasing attention by U.S. firms to the international market. Similarly, domestic producers will continue to face substantial import competition.

The U.S. Economy

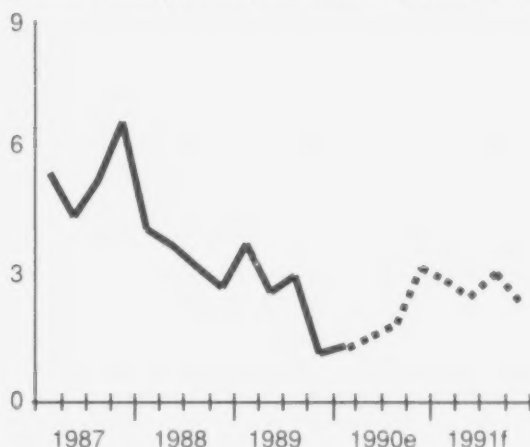
Near Term

Current State of the Economy

The U.S. economy is still growing, but the pace has slowed. The year began with a burst of activity, as unusually mild weather boosted consumer spending, housing, and nonresidential building. By the end of the first quarter, however, these earlier sharp gains were being reversed. Growth for the entire first quarter was revised down to an anemic 1.3%, similar to the 1.1% growth of the prior quarter.

Just as the numbers of January and February probably overstated the underlying strength of the economy, the numbers for March and April are likely to have exaggerated the weakness. Real GNP growth during the second quarter, however, is expected to be reported at less than 2%.

Real GNP Slow until Year-End
(Percent change from prior quarter, annual rate)



Budget Summits and Monetary Balancing

Forecasts of a ballooning deficit have suddenly brought the federal budget to the "front burner." Weakness in corporate profits has dampened revenues, while interest expense and cost of the S&L bailout have turned out to be substantially higher than initially estimated by the administration. The deficit estimates for fiscal 1991 are currently close to \$190 billion versus a Gramm-Rudman constraint of \$74 billion (\$64 billion plus a \$10 billion "cushion").

It now appears inevitable that the Gramm-Rudman targets will have to be deferred to avoid deep cuts in spending or steep increases in taxes. A compromise plan is likely to be reached providing for some slowing in spending growth and some scattered tax increases (including hikes in various user fees).

The deficit for fiscal 1991 is still likely to be in the range of \$150-\$160 billion.

A general concern exists that spending curbs or tax increases could slow the economy severely. In view of such fears, Congress and the White House are unlikely to take any draconian steps. In addition, Federal Reserve actions to tighten or ease will be the dominant force determining the direction of the economy.

In terms of the monetary base (currency plus bank reserves), monetary policy appeared very stimulative during the first quarter of 1990. The base exploded at an annual rate of close to 9%. Much of this gain, however, was in currency, partly reflecting increased demands from abroad. Bank reserves edged up at a sluggish rate of only 2.5% in the first quarter and are likely to have been flat in the second quarter.

As reserve growth remains weak in the near term, because of Fed reluctance to ease, a return to more normal currency growth could drive base growth below a 4% rate by the third quarter. If the economy continues to be weak into the summer months, as we expect, a new round of monetary easing should ensue, with a revival of reserve and monetary growth by the end of 1990. We assume that the Fed will allow a moderate growth of the monetary base in 1991 of slightly less than 5%.

Outlook for Growth

Despite a pickup in economic activity late in 1990, we expect real GNP to expand only 2.0% on a fourth-quarter-to-fourth-quarter basis this year, compared with a gain of 2.6% in 1989. We look for somewhat higher growth in 1991, with a gain of 2.7% in real GNP.

What will be the impact of this growth on jobs and profits? Nonfarm payrolls continued to climb rapidly in 1989, with a fourth-quarter-to-fourth-quarter gain of 2.6 million jobs. Although manufacturing employment peaked in March 1989 and has continued to drift lower since then, the broad services sector (encompassing retail and wholesale trade, government, transportation, as well as various business or personal services and health care) has continued to expand.

Concerns about profit margins are likely to slow hiring in the service sector in the latter part of 1990. Consequently, we expect nonfarm payrolls to show a more moderate gain of 1.8 million new jobs this year. In view of relatively slow growth of the labor force, the jobless rate is likely to rise to a monthly peak of only about 5.5% later in 1990 from an average of 5.2% in the first quarter of the year. It would then drift back to 5.1% by the end of 1991, a level which today represents essentially full employment in the United States.

Profits have borne the brunt of the slowdown in

MAJOR ECONOMIC INDICATORS

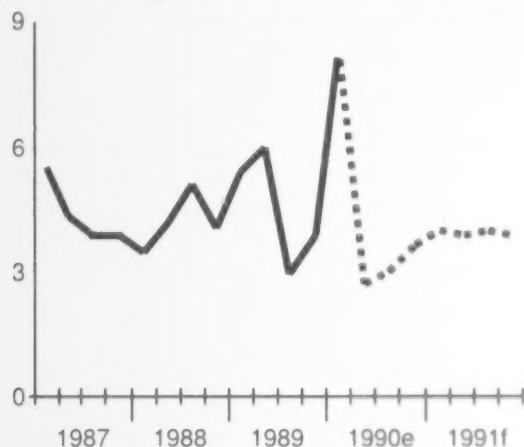
	QUARTERLY										4th QUARTER			
	1989					1990					1991			
	I	II	III	IV	Actual	I	II	III	IV	Forecast	I	II	III	IV
						Forecast					Forecast			
GROSS NATIONAL PRODUCT (Billions of \$, annual rate)	5113.1	5201.7	5281.0	5340.2	5431.4	5500.5	5574.2	5669.5	5763.7	5853.7	5953.8	6046.8	6140.8	6235.8
% Change, annual rate	7.9	7.1	6.2	4.6	7.0	5.2	5.5	7.0	6.8	6.4	7.0	6.4	6.7	6.7
REAL GNP (Billions of 1982 \$, a.r.)	4106.8	4132.5	4162.9	4174.1	4188.0	4204.7	4224.5	4257.9	4288.4	4315.0	4348.0	4373.9	4404.8	4435.7
% Change, annual rate	3.7	2.5	3.0	1.1	1.3	1.6	1.9	3.2	2.9	2.5	3.1	2.4	2.7	2.7
REAL FINAL DOMESTIC SALES* (Billions of 1982 \$, a.r.)	4140.6	4161.5	4205.9	4205.2	4240.8	4242.1	4252.6	4280.6	4305.7	4328.7	4357.2	4382.3	4407.3	4432.3
% Change, annual rate	1.3	2.0	4.3	-0.1	3.4	0.1	1.0	2.7	2.4	2.2	2.7	2.3	2.6	2.4
REAL CHANGE IN INVENTORIES (Billions of 1982 \$, a.r.)	24.5	19.1	21.9	22.2	5.9	2.5	6.5	9.7	13.0	17.2	23.0	24.5	22.2	N.A.
GNP DEFLATOR (1982=100)	124.5	125.9	126.9	127.9	129.7	130.8	132.0	133.2	134.4	135.7	136.9	138.2	139.5	140.8
% Change, annual rate	4.0	4.6	3.2	3.2	5.7	3.5	3.5	3.7	3.8	3.8	3.8	3.9	4.1	3.8
CONSUMER PRICE INDEX (1982=100)	121.9	123.7	124.6	125.8	128.3	129.2	130.2	131.4	132.7	134.0	135.4	136.7	138.0	139.3
% Change, annual rate	5.4	6.0	2.9	3.9	8.2	2.6	3.1	3.7	4.1	4.0	4.1	4.0	4.2	4.0
AUTO SALES (Millions, annual rate)	9.8	10.3	10.8	8.7	9.7	9.4	9.6	9.7	9.8	9.8	10.0	9.8	9.9	9.8
HOUSING STARTS (Millions, annual rate)	1.51	1.35	1.34	1.35	1.46	1.27	1.33	1.43	1.45	1.45	1.47	1.46	1.38	1.37
INDUSTRIAL PRODUCTION (1987=100)	107.7	108.4	108.1	108.1	108.4	108.8	109.2	109.9	110.6	111.3	112.1	112.7	113.4	114.1
% Change, annual rate	3.0	2.6	1.1	0.0	1.1	1.3	1.6	2.8	2.6	2.4	2.9	2.3	2.6	2.5
NONFARM EMPLOYMENT (Millions)	107.7	108.3	108.9	109.4	110.2	110.6	110.8	111.1	111.9	112.5	113.3	114.0	114.7	115.4
UNEMPLOYMENT RATE ALL WORKERS (Percent)	5.1	5.2	5.2	5.3	5.2	5.3	5.4	5.3	5.3	5.2	5.2	5.1	5.3	5.1
CORPORATE PRETAX OPERATING PROFITS (Billions of \$, annual rate)	316.3	307.8	295.2	285.9	287.8	290.0	293.0	300.0	306.0	312.0	318.0	325.0	330.0	335.0
% Change over year ago	-0.6	-5.4	-10.8	-16.0	-9.0	-5.8	-0.7	4.9	6.3	7.6	8.5	8.3	8.3	8.3
PROFITS AFTER TAXES (Billions of \$, annual rate)	173.6	161.1	152.4	156.7	157.0	157.5	158.0	162.0	165.0	169.0	173.0	177.0	180.0	183.0
% Change over year ago	8.6	-3.5	-12.0	-10.8	-9.6	-2.2	3.7	3.4	5.1	7.3	9.5	9.3	9.3	9.3
MONEY BASE (Billions of \$, a.r.)	277.3	278.6	280.8	283.7	289.7	294.0	296.6	301.0	304.3	307.3	311.4	315.3	318.7	323.0
% Change, annual rate	4.4	1.8	3.3	4.1	8.8	6.1	3.6	6.0	4.5	4.0	5.5	5.1	5.1	4.8

NOTE: All quarterly series are seasonally adjusted. % change, annual rate calculated from prior quarter; calculations based on unrounded data. a.r. = annual rate. *Excluding Commodity Credit Corp. purchases.

**Annual total. N.A. = Not applicable.

economic growth that has been under way since the spring of 1989. Most major industries reported poor results last year, with profit margins approaching recession levels. Manufacturers in particular, however, have cut costs further and should benefit from any improvement in orders or sales. Consequently, the picture for both profits and cash flow should gradually improve as 1990 proceeds. Performance in 1991 should build on that improvement.

Consumer-Price Spiral Unwinds
(Percent change from prior quarter, annual rate)



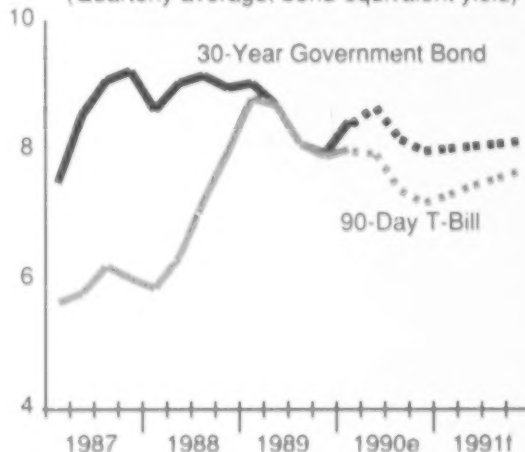
Inflation and Interest Rates—Overreaction to Bad News?

The financial markets were shocked as producer and consumer prices soared seemingly out of control early in 1990. We believe, however, that much of the surge in prices was temporary. Energy and food prices, which had escalated, have been retreating. Earlier-than-normal introduction of spring clothing sent apparel prices skyrocketing, but discounting should take place this spring. General softness in the housing market should moderate the rise in housing costs (treated in the consumer price index on a "rental

equivalent basis").

The necessary ingredient for ongoing high rates of inflation is monetary growth well above the potential growth of the economy. Federal Reserve policy during the past two years appears to have been too restrictive to sustain much higher inflation. Consequently, we expect consumer prices, which surged at an annual rate of more than 8% in the first quarter, to rise at an annual rate averaging about 3% during the second and third quarters. For all of 1990 (fourth quarter to fourth quarter), our forecast is for consumer prices to rise 4.5%, slightly below last year's increase of 4.6%. We continue to expect that consumer prices next year will increase by only 4.0%.

Lower Interest Rates through Summer
(Quarterly average, bond-equivalent yield)



Both short- and long-term interest rates are likely to drift lower during the next few months. We expect the Federal Reserve to reduce its target for the federal funds rate to 7.75% by this September from the 8.25% level of May. Signs of a relatively sluggish economy will be key to pushing short-term interest rates lower. We look for the prime rate to move from its May level of 10.0%

FORECAST OF INTEREST RATES

(Quarterly averages)

	1989					1990			1991			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term	Actual					Forecast						
Fed Funds (Overnight)	9.44	9.73	9.08	8.61	8.25	8.21	7.88	7.75	7.98	8.10	8.33	8.44
Treasury Bills (3-month) ¹	8.54	8.41	7.84	7.65	7.76	7.71	7.17	7.00	7.10	7.25	7.38	7.50
CDs (3-month, secondary)	9.60	9.58	8.73	8.44	8.24	8.30	7.86	7.76	8.01	8.23	8.38	8.50
Eurodollar (3-month)	9.69	9.66	8.79	8.49	8.28	8.31	7.89	7.79	8.04	8.27	8.41	8.54
Prime Rate	10.98	11.36	10.66	10.50	10.04	10.00	9.58	9.50	9.58	10.00	10.00	10.08
Long-Term												
U.S. Government Bonds (30-yr) ²	9.04	8.71	8.12	7.93	8.44	8.63	8.22	8.00	8.05	8.10	8.15	8.20
Corporate Aaa (Moody's)	9.69	9.49	8.97	8.89	9.19	9.36	8.98	8.80	8.83	8.88	8.93	8.98
Mortgage Rate (Fixed) ³	10.80	10.67	10.00	9.82	10.12	10.33	10.00	9.84	9.89	9.94	9.99	10.04

(1) Bank discount basis. (2) Yields adjusted to constant maturities. (3) Contract rates on first mortgages, conventional market.

to around 9.5% in the next few months.

Long-term bond rates, which shot up early this year, are expected to fall in response to improvement in reported inflation rates. The 30-year government bond yield, which pierced the 9% mark this spring, is expected to fall back to about 8% by the latter part of this year. This decrease would return it to the level attained at the end of 1989. Fixed-rate, 30-year mortgages should move back toward 10% during the next few months, after approaching 11% this spring.

Faster economic growth in the final part of 1990 can be expected to cause both short- and long-term interest rates to stabilize. Interest rates would then rise gradually through 1991.

Medium Term Key Policy Decisions

Decisions by the Federal Reserve will greatly influence the general outline of the economy during the next five years in terms of growth and inflation. The Federal Reserve has indicated its intention of achieving zero inflation or stable prices. Although such a goal would have very positive implications for the economy, it may be difficult to attain.

Economic growth and price stability are not incompatible goals; to the contrary they are complementary. However, because firms and individuals may not adjust their inflation expectations down quickly enough, efforts to drive inflation lower may cause temporary job losses and rising unemployment. This "transition" problem may, therefore, make the zero-inflation target politically intolerable.

Nevertheless, the current Federal Reserve appears intent on reducing or at least capping inflation. Simultaneously, some Fed officials see the economy's potential real growth rate as about 2.5% a year. These policy views carry strong implications for business planning during the next five years: inflation and economic growth are likely to be held at relatively moderate levels. Wide swings between "tight" and "easy" monetary policy are likely to be avoided, facilitating a somewhat more stable planning environment for many companies in contrast to the volatility during much of the 1980s.

Fiscal policy will be struggling with the added costs of the S&L problem. The basic approach likely to be used to cope with the deficit will be an effort to "grow out of the problem." If the deficit can be held to about \$150 billion, for example, it would diminish relative to GNP to 2.0% in fiscal 1995 from close to 3.5% in 1990 and a peak of 6.3% in 1983.

Defense spending is expected to continue to shrink in real terms during the next five years. We assume that defense authority and outlays will both decline an average of 4% a year in real terms through 1995. The

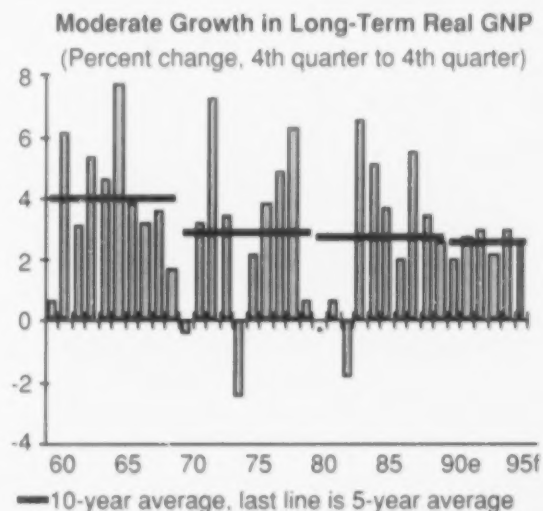
defense establishment will not be dismantled; too much uncertainty exists in various areas of the world. Production schedules, however, will be stretched out, even if this leads to much less economic rates of production. Conventional forces will be cut and various bases are likely to be closed. R&D spending, however, will continue to receive sizable support to move toward a military organization that will be smaller but more technically advanced.

Besides monetary and fiscal policies, the third policy area that will have important implications for the next five years involves regulation. Environmental issues will move to the forefront; businesses will either be required by law or given incentives to reduce pollutants. Mandated employee benefits also will be an important issue. Extending health insurance to the approximately 37 million individuals now lacking coverage seems to be an objective of many lawmakers at both the state and federal levels. Besides health care, firms may be required to provide or pay for other benefits, such as child care.

Five-Year Projections—Favorable

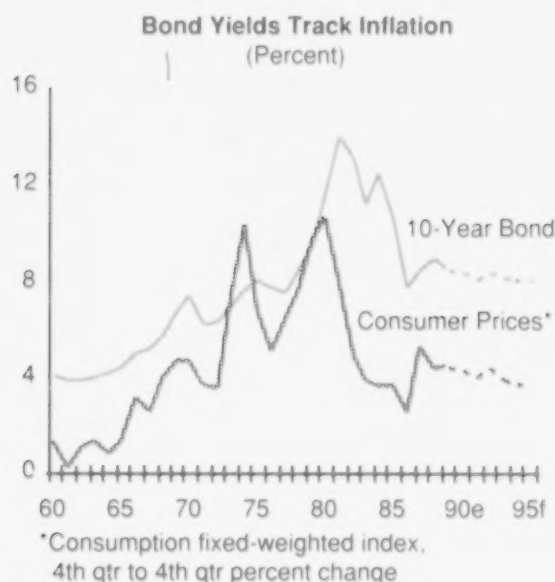
We expect real GNP to expand at a rate averaging 2.6% annually in the five years through 1995. This rate is probably somewhat less than the economy's potential growth in our view, but it is close to the Federal Reserve's estimate of sustainable, noninflationary growth. Although labor force growth will slow substantially to only about 1% a year during the next five years, investment in new equipment, advances in technology, restructuring, and a more experienced work force should help raise productivity substantially. The economy will be operating at essentially full employment during the next five years.

We expect consumer prices to rise an average of about 4% a year during 1991-95. Inflation below 4%



would be beneficial to the economy, but the expected rate would compare favorably with the 4.5-5.0% average inflation rate (depending on how measured) during the past thirty years.

Inflation will be the most important factor determining the level of interest rates. We expect 30-year government bond yields to average 8.2% over the next five years. If investors extrapolate the 4% inflation rate into the future, this would imply a real rate of about 4%.



What is a reasonable real rate of return to expect? History provides a limited guide. The implied real return on long-term Treasury bonds averaged 2.5% in the 1960s, 0.4% in the 1970s, and 5.3% in the 1980s. These swings in realized real rates reflected the unexpected upsurge in inflation from an average of 2.1% in the '60s to 6.5% in the '70s and back down to 5.1% in the '80s.

We assume in this forecast a normal real yield of 4%. This rate encompasses the productivity of capital and a premium for various uncertainties, ranging from

global questions about the Soviet Union and Japan to domestic concerns about the budget and monetary policy. The investment demands of Eastern Europe could push up real interest rates if the world economy is operating at such high rates of capacity utilization that higher interest rates are necessary to induce more saving.

Monetary policy is likely to continue to be conducted with the Federal Reserve targeting the federal funds rate. Financial markets will attempt to anticipate the Fed's next policy move, with short-term interest rates typically leading the funds rate in both upswings and downturns. Our forecast is for three-month Treasury bill rates to average about 7.3% during the next five years (7.6% on a bond-equivalent basis).

Is the Business Cycle Obsolete?

If our forecast turns out to be correct, it will mean thirteen years of economic expansion, the longest in history. Although many business firms might question whether such a forecast is plausible, there are several reasons why the expansion is likely to continue: (1) Economic policies are likely to be less volatile, in part, because of discipline imposed by international financial markets. (2) Computers are enabling companies to control inventories more effectively. (3) The U.S. economy has become sufficiently diversified so that slowdowns affect individual sectors or regions in a pattern of "rolling adjustments." (4) Further growth of the services sector will help cushion the economy from fluctuations in the goods-producing area.

Recessions are not inevitable but have typically been caused by a sequence of excessive fiscal/monetary stimulus, rising inflation, and a reaction of monetary tightening. The next five years stand a good chance of avoiding that chain of events.

ECONOMIC PROJECTIONS

	Fourth Quarter				Annual Average			
	Real GNP*	Consumer Prices*	3-Mo. T-Bill	30-Yr. Govt. Bonds	Real GNP*	Consumer Prices*	3-Mo. T-Bill	30-Yr. Govt. Bonds
1989 actual	2.6	4.6	7.65	7.93	3.0	4.8	8.11	8.45
1990	2.0	4.5	7.00	8.00	1.8	4.7	7.41	8.34
1991	2.7	4.0	7.50	8.20	2.7	3.8	7.31	8.13
1992	2.9	4.4	7.80	8.40	2.8	4.2	7.61	8.36
1993	2.1	4.0	6.80	8.00	2.6	4.1	7.34	8.20
1994	3.0	3.7	7.30	8.15	2.6	3.9	7.14	8.14
1995	2.5	3.9	7.25	8.15	2.7	3.8	7.25	8.15

*Percent change over prior year.

Industry Perspective

Near Term

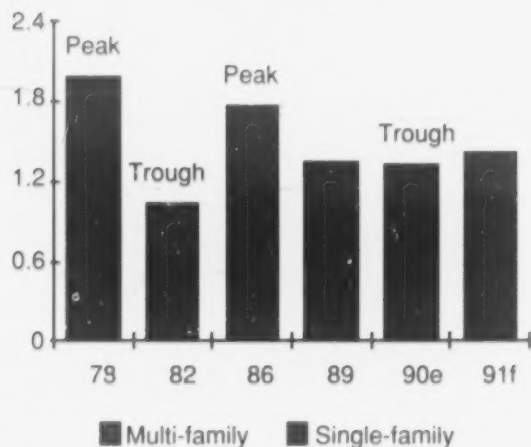
Key Segments Diverge

Sizable divergence of various sectors will distinguish performance of the U.S. economy in 1990 and 1991. Consumer spending will grow only moderately in 1990 before picking up to a greater extent in 1991. We expect the dollar value of retail sales to be up about 5% this year and 6% in 1991. Partly in response to a substantial debt burden, households are beginning to save more.

Spending on durable goods will be relatively modest this year. Sales of cars and light trucks are likely to reach approximately 14.2 million in 1990, down from 14.5 million in 1989. Total sales for 1991 are forecast at 14.6 million vehicles.

Americans are now keeping their cars longer. With the average price of a new car now close to \$16,000, car loans have been lengthened to make monthly financing payments more tolerable. The popularity of the five-year car loan has driven the average length of a car loan to nearly 55 months. Meanwhile, the average age of a car is now over 7.5 years, in contrast to an average of 5.5 years in the late 1960s.

Housing Starts Ease Further in 1990
(Millions of units)



Housing will be one of the weakest sectors in 1990 before showing modest improvement in 1991. We now expect total housing starts to slightly trail last year's total and equal 1.37 million units in 1990. Starts of single-family units will rise by 3%, while multi-family units will be lower. The climb in mortgage rates earlier this year and the general tightening of credit to the building industry have been major constraints. Lower mortgage rates and a gradual step-up in lending should allow a 6% increase in housing starts in 1991 to 1.46 million units.

The generally overbuilt situation of office buildings, hotels, and shopping centers will push the value of permits for total nonresidential building down about 5% this year. Industrial space appears to be one of the few areas where overbuilding is not almost universal. After two years of decline, the value of nonresidential permits could start to stabilize in 1991.

Exports and capital equipment should do relatively well in 1990. Demand is strong in several European countries, Japan, and in the Newly Industrializing Economies (NIEs) of the Far East. Domestically, demand for computers and other high-tech equipment has been stronger than anticipated so far this year, as companies seek to raise productivity.

The services sector is likely to record a lower rate of job expansion during the balance of 1990, compared with the large gains of recent years. Some of the slowdown that has faced the goods sector for over a year is beginning to spill over into various services. Profit margins continue under pressure for many retailers. Companies that have assumed much higher leverage levels will remain especially vulnerable to slower sales growth.

Medium Term

Growth Locomotives and Followers

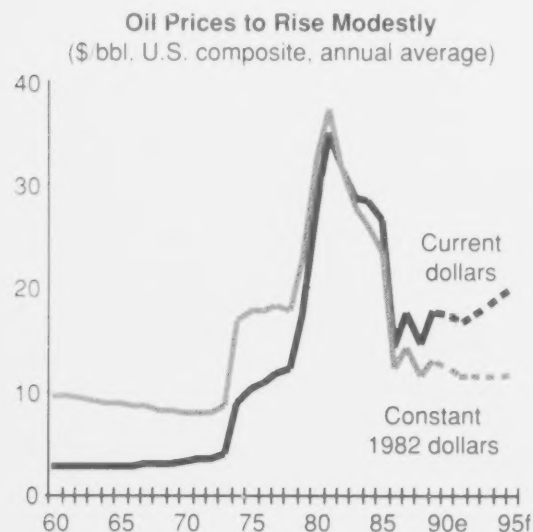
Exports and business capital equipment are likely to continue as the primary "engines of growth" in the period through 1995. Consumer spending will grow moderately in line with incomes. Housing starts are likely to average between 1.4 and 1.5 million units in the five years through 1995 in response to a slowing in the rate of new household formation compared with trends of the past two decades.

Oil Prices—Which Direction?

Between now and the end of 1991, we assume that oil prices in terms of the benchmark, West Texas Intermediate, will trade generally in the \$17-\$19 a barrel range. OPEC is unlikely to be able to enforce the kinds of production cutbacks necessary to drive prices substantially above the top end of that range for a sustained period of time. Weather-related demand or other developments could, however, push prices temporarily higher. On the opposite end, a steep slide in oil prices below \$17 a barrel would trigger efforts by OPEC to curb output by its members.

Since 1960, oil prices in the United States have climbed an average of about 1% per year faster than the rise in non-energy consumer prices. Several factors will be operating on both the demand and supply sides during the next few years. Continuation of recent trends of declining production in the United States and the Soviet Union could combine with sizable economic

growth and energy demand in most parts of the world (including higher demands in Eastern Europe) to push prices higher. Countering those forces are the possibilities of further discoveries of energy reserves and expanding production by OPEC members. On balance, we assume an extension of the trend of real price increases of about 1% per year through 1995.

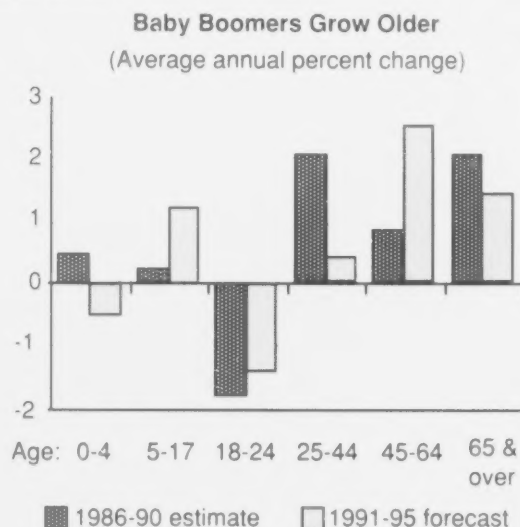


Demographics—Where Are the Baby Boomers Now?

The most rapidly growing segment of the population in the five years to 1995 will be the 45-64 age bracket. This will mark the movement of the first wave of "baby boomers" into the lower part of that age group. In contrast, two segments will see actual shrinkage in their numbers: children under five years of age and young adults 18-24 years old.

Individuals aged 65 and over will see a relatively slow average growth in population of about 1.5% per

year through 1995. By that year, however, there will be 34 million senior citizens. Although they will comprise only about 13% of the population, those 65 or over will account for about 35% of spending in the large health-care sector.



Strong and Weak Industries through 1995

Demographics, basic fiscal and monetary policies, the U.S. defense posture, and international trends will all contribute to determining which industries will be strongest or weakest during the next five years. At this point, prospects appear especially favorable for the high-technology industry (including computers, software, and telecommunications equipment), pharmaceuticals, commercial aircraft, and environmental engineering. Services and products related to the travel/tourism and recreation/entertainment sectors also should do well. Prospects seem to be softest for defense firms, commercial construction, autos, railroads, and water transportation firms.

U.S. RESIDENT POPULATION BY AGE

(Thousands and share of total)

Age Cohort	1980	1985	1990e	1995f
0 - 4	16,348	18,004	18,553	18,074
	7.2%	7.5%	7.4%	6.9%
5 - 17	47,407	44,975	45,631	48,723
	20.9	18.8	18.2	18.6
18 - 24	30,022	28,500	26,075	24,361
	13.3	11.9	10.4	9.3
25 - 44	62,717	73,791	81,735	83,824
	27.7	30.9	32.6	32.0
45 - 64	44,503	44,926	46,885	53,176
	19.6	18.8	18.7	20.3
65 & over	25,549	28,540	31,591	34,053
	11.3	12.0	12.6	13.0

Financial Institutions

Near Term

S&L Restructuring in Trouble

Nine months after passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), the restructuring of the savings and loan (S&L) industry and the rescue or sale of failed institutions have run into serious problems. The Resolution Trust Corporation (RTC) has only sold or liquidated 90 S&Ls to date. The RTC has about 330 institutions in conservatorship and will likely seize over 450 more thrifts that do not meet new capital requirements. The RTC and its Oversight Board have been mired in a bureaucratic maze and have achieved limited success in finding buyers for insolvent thrifts. The RTC has also been hamstrung in pricing assets within the "95% of market value" rule mandated by FIRREA for sale of foreclosed real estate.

In response to widespread criticism, the chairman of the RTC has set the ambitious goal of resolving 140 cases by mid 1990. The RTC has pledged to develop a new sales mentality consisting of no longer acting as a warehouse for insolvent S&Ls, aggressively marking down property values as much as 20%, offering extended warranties to buyers, and helping buyers with financing. "Market value" will no longer be based on appraised value but will be defined as the price necessary to sell a given property.

It has become painfully evident that FIRREA has serious flaws. The legislation failed to address the most serious defects in the design of thrift institutions. One of these is the mismatch of maturities between assets and liabilities. Another defect—inadequate diversification—was actually made worse by the new qualified-lender-test, which requires thrifts to have 70% of their assets in mortgage-related assets, instead of the previous 60%, in order to receive favored tax treatment. On top of this is the lack of any market discipline in the pricing and structure of deposit insurance. It is quite likely that Congress will engage in "damage control" in 1991, enacting an omnibus financial bill to include: (a) technical corrections of the 1989 law, (b) possibly some type of deposit insurance reform, and (c) some easing of the Glass-Steagall and/or McFadden Acts.

Measured in terms of the cost to taxpayers and the extent of fraud, regulatory negligence, and delay in recognizing the severity of the problem, the S&L crisis is by far the worst financial debacle in U. S. history. Estimates of the cost over the next ten years have escalated sharply from \$166 billion in the FIRREA bill to \$300-\$400 billion currently. Whether

this increased outlay will be financed through higher taxes or increased borrowing remains to be seen.

Credit Crunch?

Recent slowing in the growth of commercial bank loans, especially real estate loans, has led to conjecture that the United States is currently facing a "credit crunch." In past cycles, "disintermediation" of the banking system led to reduced bank lending, followed by a decline in overall economic growth. The last credit crunch this country experienced was in 1980, when bank reserve growth slowed substantially and was followed by a severe recession.

Since early 1989, growth of bank reserves has dropped sharply; reserves actually declined late last year and have continued to be weak. As a result, growth of total bank credit has slowed sharply. More conservative bank credit standards and stricter scrutiny by regulators have reduced the availability of credit to lower quality borrowers. Growth of real estate loans by commercial banks had been very strong through the first seven years of this economic expansion. The thrift industry crisis initially triggered sharply increased commercial bank lending to real estate, as S&Ls were forced to shrink their assets. The growth rate of bank loans for real estate peaked in mid 1987 at 20%, moderating to 12% in early 1990. Areas of the country that have been hardest hit by falling real estate values, such as Arizona and New England, are finding it more difficult to obtain financing for real estate than are rapid growth regions such as the Pacific Northwest and Las Vegas. Caution is now the key word in real estate lending everywhere due to potential overexposure, continued regulatory pressure, and excess capacity.

Commercial and industrial loans grew at about a 6% rate in 1988 and 1989, but at only a 4% rate in early 1990. Slower economic growth has meant softer business loan demand even though interest rates are lower. C&I loan growth is now especially weak for retail trade and finance companies. Healthier companies have continued to increase their utilization of the commercial paper market as an alternative to bank borrowing. We expect that the Fed will ease monetary policy somewhat in the second half of 1990, as inflation fears diminish and concerns over the economy's strength rise. While total bank credit growth has slowed, it has not actually contracted as in previous cycles. Thus, we do not foresee a classic credit crunch nor the recession that would follow under such a scenario.

Medium Term

Legislation to Modernize Banks

The overcapacity in American banking has become a focal issue in the 1990s, as the competitiveness of

U.S. banks in global markets has weakened. Restrictions against interstate bank expansion in the United States have largely been responsible for the large number of banks, close to 12,000, operating throughout the nation, the majority of which are relatively small. By comparison, European, Canadian, and Japanese banks can operate nationwide and have benefited from the broad coverage of their domestic markets to develop business in foreign countries. In the five years ahead, further liberalization of restrictive laws should accelerate the consolidation of U.S. banks, especially as superregional banks seek to widen their market presence. By 1995, the number of U.S. banks is likely to shrink to less than 10,000.

The U. S. banking industry is likely to see some movement towards universal banking—especially wider participation in the securities underwriting business—in the first half of the 1990s. The catalyst for this is the approach of EC 92, when access to a unified market is expected to make European banks stronger and better positioned to compete globally. Since the German model of commingling banking with securities and insurance powers is likely to prevail in many EC countries, enormous pressure will be placed on American and Japanese banking authorities to remove or ease restrictions on their banks. Despite the preoccupation of regulators and Congress with the S&L crisis, financial modernization—perhaps excluding the mixing of banking and commerce—could progress beyond the discussion stage by the mid 1990s. This may take the form of a financial-services holding company model with safeguards against conflicts of interest and unfair competition. Canadian banks now operate in such an environment.

Higher capital standards could be on the horizon for U.S. banks in the wake of the rise in bank failures and collapse of the thrift industry insurance fund. In a major public statement in May 1990, Federal Reserve Chairman Alan Greenspan called for even higher capital requirements than the 8% risk-based standard embodied in the Basel Agreement. He contends that banks have been safer and sounder in those periods of history when capital ratios were higher than they were in the 1980s and that the federal safety net (deposit insurance, the discount window, and transfer of funds through "Fed wire") represents a subsidy that should be protected from abuse by the less responsible segment of banking. Bank failures, which have been few since the 1930s, escalated to a high of 207 in 1989. However, with a fairly sharp decline in the FDIC's list of "problem banks" from a peak of 1,559 in 1987 to 1,080 as of March 1990, it is likely that fewer banks—less than 120—will fail in 1990.

Bank Strategies

As the 1990s unfold, many of the largest U.S. banking institutions are experiencing a host of adverse market fundamentals. These include nonperforming loans in real estate, highly leveraged transactions, and, in a few cases, loans to Third World countries where interest payments have been suspended. Meanwhile, regulators have become increasingly stringent in requiring larger reserves against future possible losses on real estate loans. Stock prices of most large banks have been depressed for nearly a year, making it more difficult to raise equity capital.

In response, banks have been forced to develop new strategies for survival and performance. About 20 superregional banks with solid earnings records and strong market capitalization have embarked on aggressive acquisition programs across state lines. There have been over 3,000 bank mergers in the nation since 1985, half of which—by dollar value—were effected by superregionals. The money-center banks are continuing to work through their loan quality problems. Only a few very large U.S. banks remain committed to enhancing their positions in global financial markets, while other U.S. banks are either maintaining a modest presence in certain regions of the world or withdrawing altogether.

There is some conjecture that Japanese banks will be forced to cut back overseas lending over the next five years because of the impact on their capital of the sizable decline in the Tokyo stock market since the start of 1990. Japanese banks held about \$300 billion in stocks and bonds as of the end of March 1990. The Bank for International Settlements in Basel has ruled that 45% of these hidden reserves may be counted in their capital-to-asset ratios, a fact which assured Japanese banks of realizing the 8% standard which must be met by 1992.

The combination of recent declines in stock and bond prices, rising interest rates, a lower-valued yen, concerns about real estate loan exposure, and a mandate by the Bank of Japan to reduce credit expansion suggests some tempering of Japanese lending overseas. Japanese banks have raised their share of U.S. banking assets from 5.4% in 1982 to 12.1% in 1989—representing a total of \$372 billion. The huge Japanese current-account surplus will continue to support lending abroad by Japanese banks in the near term, but, given their recent troubles, the rate of expansion by Japanese banks should slow in the 1991-95 period, depending on the nature of the correction of Japanese stock and land values.

First Interstate Territory

Near-Term

The 19-state group of First Interstate's banking territory (affiliates and licensees) can be expected to post job and income growth above the national averages in both 1990 and 1991. At the end of this year's first quarter, the nation's six fastest growing states in terms of employment were all located in the FI region: Nevada, Idaho, Washington, Alaska, Utah, and Oregon.

Differences in Regional Performance

The Pacific Northwest (Alaska, Idaho, Oregon, and Washington) will continue as the fastest growing region in the Territory in 1990 and 1991, extending the pattern of 1989. Helped by higher oil prices, Alaska's economy has rebounded, and tourism should register considerable growth during the next two years. Idaho, Oregon, and Washington are experiencing a "mini boom," fueled by strong export demand, soaring aircraft orders, and the current attraction of business firms and families to the Pacific Northwest.

The Pacific Southwest (Arizona, California, Hawaii, and Nevada) will post solid job gains. Despite problems in real estate, Arizona's overall economy continues to expand. Nonfarm payrolls are likely to be up nearly 3% this year, following a gain of 2.7% in 1989. Defense cuts will temper California's gains. Nevada's explosive expansion will cool, and Hawaii's growth will moderate. Nevertheless, each of the Pacific Southwest states will outperform the nation as a whole in terms of job increases in 1990.

The Rocky Mountain states (Colorado, Montana, New Mexico, Utah, and Wyoming) continue to recover with better prices for oil and natural gas. Utah has developed a strong position in high technology and services, which is yielding significant benefits in terms of job growth. The other states are gradually working off the overhang of excess capacity added during the "oil boom" days of the 1980s.

The Southern Tier states (Louisiana, Oklahoma, and Texas) also are making strides. Although job growth in Louisiana and Oklahoma remains quite weak, Texas is catching up with the national average. Uncertainty plagues real estate markets, as the Resolution Trust Corporation (RTC) attempts to liquidate its holdings.

The Northern Plains states (Iowa and the Dakotas) are likely to record growth slightly above the national average in 1990. The farm sector, especially in Iowa, has improved substantially with a strong export market. Farmers have generally reduced their debt burdens and farmland prices are rising again.

Medium Term

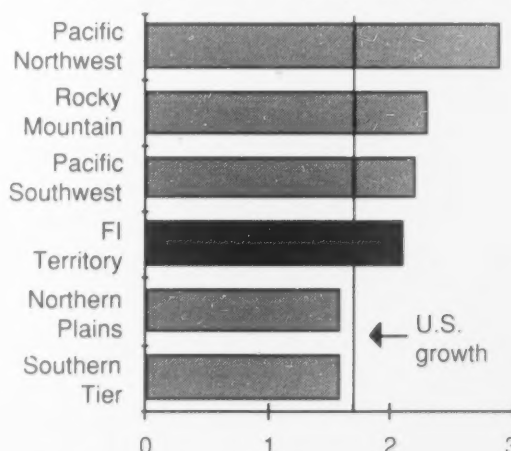
A review of our employment forecast through 1995

might give the impression that various state economies will be more sluggish than in recent years. Job growth nationally is projected at an average of 1.7% per year in the next five years, in contrast to a gain of 2.8% in 1989. Much faster job growth will be difficult given the slowing in labor force growth because of expected demographic trends. However, productivity should show better performance during the next few years, facilitating better gains in real incomes.

Positives and Constraints in the Outlook

A number of favorable forces should support growth in the FI region during the medium term. With the exception of Alaska, all of the states are affected by the general pattern of the national business cycle. Hence, continuation of the national economic expansion, as in our forecast, should be a major force supporting growth in the Territory.

Pacific Northwest Leads 1991-95 Growth
(Average annual employment gain)



A modest rise in energy prices (oil prices up an average of one percent per year in real terms) should help sustain a steady level of oil and gas exploration and development in the Southern Tier and Rocky Mountain states. Although farm price supports are likely to be frozen at current levels, foreign demand for U.S. agricultural products should be good.

Export demand will be important for a number of industries throughout the Territory. In addition to farm goods, sizable markets abroad should exist for lumber and wood products, high-technology items, and various consumer goods. Demographic trends also appear favorable. The rapid growth of the 45-54 age bracket should bolster tourism for such states as Nevada, California, and Hawaii, while foreign tourism in the United States should also be substantial.

The Territory will face certain constraints. The significant decline in defense spending (average of 4%

per year in real terms) will affect a number of states, especially California and, possibly, New Mexico. The boom in commercial aircraft production, however, will provide some offset. U.S. housing starts averaging in the range of 1.4 to 1.5 million units over the forecast period will focus the lumber and wood products market more on remodeling and foreign markets. The excess supply of office and commercial space will curb new construction activity in key markets in Arizona, Texas, and Colorado throughout most of the period to 1995.

Environmental developments will have differential effects in the Territory. For example, while efforts to reduce air pollution may dampen manufacturing activity in Southern California, Wyoming should benefit from higher demands for its low-sulfur coal.

FI Region to Outperform Nation

In the five years through 1995, we expect the First Interstate region to show average employment growth of 2.1% per year versus the national average growth of 1.7%. Personal income growth in the Territory will also exceed the national average by a small margin, with an average annual gain of 6.9%, compared with a national average growth of 6.7%.

The Pacific Northwest will remain the growth leader over the medium term. The fastest growing states in the period through 1995 will be Nevada, Arizona, Utah, and Washington. The slowest growing states are expected to be Oklahoma, Louisiana, and Wyoming. All states in the Territory, however, are projected to record positive gains in employment over the five-year span.

Base Closings—Concentrated

The Department of Defense has identified 114 military bases/facilities for possible closing and targeted 82 for realignment. Although this so-called "hit list" carries a tone of finality, considerable wrangling can be expected before the scheduled 1994 completion date. Congress must be informed of actions that would cause any loss amounting to 300 civilian jobs, one-half the civilian work force, or as many as 1,000 total workers. In the budget approval process, Congressional bargaining could paralyze the base closure program.

Several forces have influenced the decision to close or realign military bases. One of the most important is the thawing of the Cold War. A sizable reduction in U.S. military bases in the next five years appears to be a widely accepted goal and is seen as contributing to federal budget reduction. Annual savings of the total program are estimated at close to \$1 billion, with a net present value over 20 years of nearly \$8 billion. Urban encroachment in regions ex-

periencing rapid population and industrial growth was one of the factors considered in selecting bases for closing. Environmental considerations also entered into the selection process.

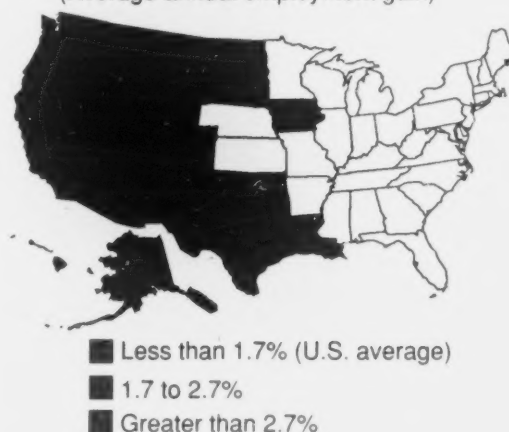
MILITARY BASE TARGETS IN FI TERRITORY 1991-94

	Closings	Reductions
AZ	1	1
CA	16	2
CO	1	1
HI	1	0
IA	0	1
LA	2	0
NV	0	2
NM	1	0
OK	0	1
OR	0	1
TX	4	5
UT	1	1
WA	0	1
FI	27	16

Note: Not affected - AK, ID, MT, ND, SD, WY.

In the 19 states comprising FI Territory, 27 bases/facilities have been identified for closing, concentrated in California (16), Texas (4), and Louisiana (2). Installations slated for reduction are located in ten states, of which the largest number will be in Texas (5), California (2), and Nevada (2). An additional 23 bases are targeted for expansion in the Territory in the 1991-94 period, especially in Arizona, Washington, Texas, and California. This realignment will reflect changes in specific missions and overall command structure. The economies of certain metropolitan areas in the Territory will experience some loss of income and jobs as a result of the base closure program, but the statewide impacts will be limited.

Fastest and Slowest Growing FI States, 1991-95 (Average annual employment gain)



NONFARM PAYROLL EMPLOYMENT FORECASTS (Thousands of jobs)

	1990		1991		1992		1993		1994		1995	
	Level	% Change	Level	% Change	Level	% Change	Level	% Change	Level	% Change	Level	% Change
Alaska	237	4.3	245	3.2	250	2.4	256	2.1	261	2.0	266	2.1
Arizona	1,499	2.9	1,553	3.6	1,616	4.0	1,661	2.8	1,712	3.1	1,769	3.3
California	12,085	2.4	13,181	2.3	13,458	2.1	13,687	1.7	13,933	1.8	14,198	1.9
Colorado	1,495	1.6	1,524	1.9	1,560	2.4	1,591	2.0	1,628	2.3	1,664	2.2
Hawaii	522	3.4	538	3.0	552	2.7	566	2.5	580	2.4	593	2.4
Idaho	388	5.5	402	3.8	414	2.8	425	2.7	436	2.6	448	2.8
Iowa	1,229	2.4	1,257	2.3	1,277	1.6	1,295	1.4	1,312	1.3	1,330	1.4
Louisiana	1,522	0.4	1,531	0.6	1,547	1.0	1,564	1.1	1,582	1.2	1,603	1.3
Montana	300	3.3	308	2.5	313	1.9	318	1.3	322	1.4	326	1.4
Nevada	621	6.7	654	5.3	685	4.7	710	3.7	735	3.5	760	3.4
New Mexico	571	1.8	582	2.0	597	2.5	611	2.4	625	2.3	640	2.4
North Dakota	265	1.9	271	2.1	276	1.9	280	1.4	284	1.6	289	1.6
Oklahoma	1,168	1.2	1,181	1.1	1,192	1.0	1,201	0.7	1,210	0.8	1,221	0.9
Oregon	1,252	3.8	1,286	2.7	1,321	2.7	1,358	2.8	1,397	2.9	1,439	3.0
South Dakota	260	2.0	287	2.2	292	2.0	296	1.4	301	1.6	306	1.6
Texas	6,939	1.9	7,071	1.9	7,212	2.0	7,335	1.7	7,467	1.8	7,616	2.0
Utah	721	4.4	748	3.7	771	3.1	793	2.8	815	2.8	838	2.9
Washington	2,150	5.1	2,236	4.0	2,309	3.3	2,367	2.5	2,426	2.5	2,489	2.6
Wyoming	197	1.7	199	1.2	202	1.4	204	0.8	205	0.9	208	1.2
Fl Territory	34,242	2.5	35,053	2.4	35,846	2.3	36,517	1.9	37,233	2.0	38,006	2.1
U.S.	110,695	1.9	112,932	2.0	115,078	1.9	116,804	1.5	118,673	1.8	120,690	1.7

PERSONAL INCOME FORECASTS (Billions of dollars)

	1990		1991		1992		1993		1994		1995	
	Level	% Change	Level	% Change	Level	% Change	Level	% Change	Level	% Change	Level	% Change
Alaska	12.3	10.0	13.4	8.9	14.3	7.0	15.2	6.4	16.2	6.2	17.2	6.3
Arizona	60.5	7.2	65.3	7.8	70.6	8.2	75.6	7.0	81.4	7.7	87.8	7.9
California	820.4	7.5	866.4	7.4	916.3	7.5	963.6	6.6	1,014.8	6.7	1,070.2	6.8
Colorado	61.5	6.0	65.4	6.3	70.0	7.0	74.4	6.3	79.3	6.5	84.4	6.4
Hawaii	22.1	8.6	23.9	8.2	25.9	8.1	27.8	7.6	29.9	7.4	32.1	7.4
Idaho	15.4	10.2	16.7	8.5	18.0	7.7	19.3	7.3	20.7	7.1	22.2	7.3
Iowa	47.1	6.9	50.3	6.8	53.5	6.3	56.5	5.7	59.7	5.6	63.1	5.7
Louisiana	60.2	5.4	63.6	5.6	67.6	6.2	71.6	6.0	76.0	6.0	80.6	6.1
Montana	12.0	7.8	12.9	7.0	13.7	6.6	14.5	5.7	15.3	5.7	16.2	5.7
Nevada	23.4	11.7	25.8	10.3	28.3	9.9	30.8	8.6	33.3	8.3	36.1	8.2
New Mexico	21.4	6.3	22.8	6.5	24.5	7.2	26.1	6.8	27.9	6.6	29.7	6.7
North Dakota	9.3	5.9	9.8	6.1	10.4	6.1	11.0	5.3	11.6	5.4	12.2	5.4
Oklahoma	48.0	5.2	50.4	5.1	53.1	5.2	55.5	4.6	58.1	4.6	60.9	4.7
Oregon	48.0	7.8	51.2	6.7	54.7	6.9	58.4	6.7	62.3	6.7	66.6	6.8
South Dakota	10.0	6.0	10.7	6.2	11.3	5.2	11.9	5.3	12.6	5.4	13.3	5.4
Texas	281.2	6.9	300.6	6.9	322.3	7.2	343.7	6.6	366.5	6.6	391.6	6.8
Utah	24.1	8.4	26.0	7.7	27.9	7.5	29.9	6.9	32.0	7.0	34.2	7.1
Washington	92.4	10.1	100.8	9.0	109.4	8.5	117.5	7.4	126.1	7.3	135.5	7.4
Wyoming	7.1	5.2	7.4	4.7	7.8	5.1	8.2	5.3	8.6	5.1	9.1	5.4
Fl Territory	1,476.5	7.4	1,583.2	7.2	1,699.5	7.3	1,811.7	6.6	1,932.2	6.7	2,062.9	6.8
U.S.	4,663.2	6.9	4,990.7	7.0	5,346.4	7.1	5,690.9	6.4	6,056.9	6.4	6,452.8	6.5

Note: Calculations based on unrounded data.

